Supreme Court, U.S.
FILED

No. 00-0000

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IN THE

United States Supreme Court

MORDECHAI GURARY,

Petitioner,

v.

NU-TECH BIO-MED, INC.,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITION FOR A WRIT OF CERTIORARI

JAROSLAWICZ & JAROS
Attorneys for the Petitioner
150 William Street
New York, New York 10038
212-227-2780

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QUESTIONS PRESENTED

The judgment below raises for review the following issue, with respect to which the Court of Appeals for the Second Circuit in this case has entered a decision which conflicts with the decision of the Court of Appeals for the Eleventh Circuit.

1. Where a complaint asserting claims under the securities laws has been found to be partially frivolous and partially not frivolous, does the Private Securities Litigation Reform Act ("PSLRA") sanctions provision, 15 U.S.C. § 78u-4(c) require an award of sanctions equal to the reasonable legal fees incurred defending the entire case, as the Second Circuit held, or just the portion of the case deemed frivolous, as the Eleventh Circuit held?

2. Does the PSLRA permit a district court to grant an award of sanctions that includes the legal fees incurred on appeal, as opposed to the legal fees incurred in the district court?

3. Was the PSLRA sanctions provision intended to be applied to claims under the securities laws that are not class actions?

PARTIES TO THE PROCEEDING

In addition to the parties identified in the caption, the following was previously a party to this action:

Isaac Winehouse; and Isaac Winehouse, d/b/a Wall and Broad Equities.

This action was dismissed by the district court as against this party, which dismissal was affirmed by the Second Circuit. This party was not a party to the appeal with respect to which a writ of certiorari is now being sought, and has no interest in the issues raised in this petition.

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Gurary v. Winehouse, 1998 U.S. Dist. LEXIS 1429, Fed. Sec. L. Rep. (CCH) P 90170 (S.D.N.Y. 1998).

In the
Supreme Court of the United States

MORDECHAI GURARY,

Petitioner,

-against-

NU-TECH BIO-MED, INC.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

OPINIONS BELOW

This petition seeks review of the judgment of the United States Court of Appeals for the Second Circuit, *Gurary v. Winehouse*, 303 F. 3d 212 (2d Cir. 2002)

STATEMENT OF JURISDICTION

The judgment which the plaintiff seeks to have reviewed was entered by the Clerk of the United States Court of Appeals for the Second Circuit on August 23, 2002.

A timely petition for rehearing was filed in the Court of Appeals for the Second Circuit. That petition was denied by order entered by the clerk of the Second Circuit on October 17, 2002.

This petition is timely since it is being brought within 90 days of the date the order denying rehearing was entered, *see* Supreme Court Rule 13(3).

Petitioner believes that this Court has jurisdiction to review on writ of certiorari pursuant to 28 U.S.C. § 1254(1).

STATUTE INVOLVED

Private Securities Litigation Reform Act, ("PSLRA"), 15 U.S.C. § 78u-4(c).

STATEMENT OF THE CASE

The petitioner is an individual investor who believed that he was the victim of a fraudulent scheme in violation of the securities laws.

The alleged scheme involved market manipulators, allegedly led by the defendant Isaac Winehouse, short selling large volumes of the stock of the defendant Nu-Tech Bio-Med, Inc. ("Nu-Tech") through the cooperation of market makers who were able, as market makers, to sell the stock short without actually having it. The short sellers were protected from the ordinary risks of short selling since they held a large number of preferred shares of Nu-Tech stock which were convertible to common stock at a very favorable price, so they were in effect selling short "against the box", and were not selling "naked" shorts. The goal was to create a "death spiral", meaning the short selling pressure would cause the bottom to drop out of the market, sending the price of the stock plummeting. This manipulation would create great

profits for the short sellers, and great losses for unfortunate investors such as the plaintiff who either owned the stock or purchased the stock during the period of the short selling.

Of course, this attempt to sell short without any risks was an improper and illegal manipulation. *See Paul F. Newton & Co. v. Texas Commerce Bank,* 630 F.3d 1111, 1113-114 (5th Cir. 1980).

The plaintiff also alleged that the defendant Nu-Tech was complicit in this scheme. Specifically, plaintiff alleged that he had personally spoken with the defendant Nu-Tech's president who promised he would thwart the short sellers by refusing to register the conversion of their convertible preferred shares into common stock. Such refusal would have negated the short sellers' risk free posture, since they would no longer have been selling short against their convertible preferred stock, and would arguably have led them to stop the short selling that was driving the stock price down. The plaintiff further alleged that Nu-Tech did not keep its president's word, and allowed the manipulators' convertible shares to be registered.

The result was a disaster. Nu-Tech stock plummeted to the vicinity of $2 per share at the time this action was commenced. The plaintiff on various dates had bought a total of 15,850 shares with a

weighted average share price of $13.13 at a total cost of $208,146. The plaintiff lost most of this investment.

The plaintiff then retained counsel and commenced this action in an effort to recoup his losses. Plaintiff asserted claims sounding in federal securities law as well as New York State law against the alleged market manipulator Winehouse, and against Nu-Tech which misled the plaintiff by registering the convertible shares after having assured the plaintiff that the convertible shares would not be registered.

This action was commenced as an individual action, not as a class action.

In a section of the plaintiff's complaint (A* 169) entitled "The Underlying Facts," the plaintiff listed the four transactions in which the plaintiff purchased Nu-Tech stock, as follows:

AMOUNT OF SHARES	PRICE PER SHARE	DATE OF PURCHASE
1,000	$14.60	1/31/96
5,500	$15.50	11/7/96
1,000	$11.75	12/24/96
8,350	$11.5625	2/18/97

* Parenthetical page references preceded by an 'A' refer to the appendix at the back of this booklet.

This listing was not part of any particular claim for relief, and was alleged as background information. Nowhere in the plaintiff's compliant did the plaintiff allege that a claim was being asserted for each of these purchases.

The defendants moved to dismiss pursuant to Fed. R. Civ. P. 12(b)(6). In their motion papers, the defendants dealt with each of the plaintiff's four purchases of Nu-Tech stock as if each were a separate cause of action arising under 17 C.F.R. § 240.10b-5.

The district court granted the defendant's motion in part, entering an order dismissing the causes of action in plaintiff's complaint arising under federal law with prejudice, and dismissing the plaintiff's state law causes of action without prejudice (A 1-9). *Gurary v. Winehouse*, 1998 U.S. Dist. LEXIS 1429, Fed. Sec. L. Rep. (CCH) P 90170 (S.D.N.Y. 1998). Four days later, the district court issued "findings" pursuant to the PSLRA, 15 U.S.C. § 78u-4(c), in which the district court found that:

> the claims and arguments made in the complaint, the motions to dismiss and the papers in opposition to the motions to dismiss were "warranted by existing law or by a nonfrivolous argument for the extension, modification, or renewal of

> existing law or the establishment of new law," Fed. R. Civ. P. 11(b)(2), were not "presented for any improper purpose," Fed. R. Civ. P. 11(b)(1), and complied with Rule 11(b) of the Federal Rules of Civil Procedure.

Gurary v. Winehouse, unpublished memorandum decision dated February 17, 1998.

The plaintiff then appealed the dismissal, and the defendant Nu-Tech cross-appealed from the district court's finding that the complaint complied with Fed. R. Civ. P. 11 and its denial of sanctions. The defendant Winehouse did not appeal.

The Second Circuit affirmed the dismissal of the complaint. *Gurary v. Winehouse,* 190 F.3d 37 (2d Cir. 1999) (hereinafter *"Gurary I"*). As will be discussed further below, that decision specifically noted that the claims against Nu-Tech were limited to the second two purchases, and that no claim was made against Nu-Tech with respect to the first two purchases. *Id.*, 190 F.3d at 44 (A 24).

On the issue of the PSLRA requirement that the district court review the complaint and render "findings" as to compliance with Rule 11, the Second Circuit concluded as follows:

> Although the judgment implicitly denied Nu-Tech's motion, the district court made no

> findings regarding compliance with Rule 11(b). As the statute required the district court to make findings, we have no choice but to remand in order to permit it to do so.

Gurary I, 190 F.3d at 47, (A 33). Thus, it appeared that the Second Circuit may have overlooked the district court's findings quoted above, which were not part of the order granting the motion to dismiss.

On remand, the district court declined to presume that the Second Circuit had erred. The court wrote:

> My order dated February 17, 1998, finding no justification for the imposition of sanctions, was part of the joint appendix on appeal and was cited in Nu-Tech's June 15, 1998 brief (p. 34) to the Court of Appeals. Accordingly, I do not assume that Court was unaware of my order, but rather take that Court's statement (190 F.3d 37 at 47) that I "made no findings regarding compliance with Rule 11(b)" as meaning that it regarded my findings as merely formalistic.

Gurary v. Winehouse, 2000 U.S. Dist. LEXIS 188 (S.D.N.Y. 2000) (A 35-36). The district court then again concluded, this time with discussion and analysis, that the complaint was not frivolous, that Rule 11 had not been violated, and that sanctions would not be granted.

Once again the defendant Nu-Tech appealed and argued to the Second Circuit that the complaint was frivolous and in violation of Rule 11, and that sanctions were required by the PSLRA.

This second appeal was heard by a different panel of the Second Circuit. *Gurary v. Winehouse,* 235 F.3d 792 (2d Cir. 2000) (hereinafter *"Gurary II"*).

In *Gurary II,* the Second Circuit concluded that the plaintiff's complaint was partially frivolous and partially not frivolous. The *Gurary II* court treated the complaint as if it alleged four separate federal securities law claims, one for each of the purchases, and then, having thus unnaturally parsed the complaint, found that the plaintiff's "claims" arising from the first two purchases of Nu-Tech stock (October 31, 1996 and November 7, 1996) were frivolous, while the claims arising from the second two purchases (December 24, 1996 and February 18, 1997) were not frivolous and could have been pleaded so as to state a viable claim, even though they had been dismissed and leave to amend the complaint had been implicitly denied. The Second Circuit then remanded this case "for the district court to determine appropriate sanctions pursuant to 15 U.S.C. § 78u-4(c)(3)(A)-(C)," *Gurary II,* 235 F.3d at 800

(A 59), with respect to the claims arising from the first two purchases that had been deemed "frivolous."[1]

On remand, the district court entered an order in the amount of approximately half the legal fees claimed to have been incurred by the defendant Nu-Tech. The district court's reasoning was that since two of the four sub-claims, or half the complaint, were deemed frivolous, and two of the four, or the other half of the complaint, were deemed not frivolous, an appropriate sanction under the PSLRA would be half the legal fees incurred.

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[1] The opinion in *Gurary II* that sanctions are warranted with respect to the first two purchases is disturbingly incongruous, since in *Gurary I* another panel of the Second Circuit had found that:

> Plaintiff's attack on the dismissal of his Rule 10b-5 claim against Nu-Tech is limited to the claim that he was deceived in making his December 24, 1996 and February 18, 1997 purchases because he relied upon Feigenbaum's declarations that Nu-Tech would not register the common into which the Winehouse group's preferred was convertible and that this should or would stop it from selling the common short.

Gurary I, 190 F.3d at 44 (A 24) (emphasis added). The finding of the panel in *Gurary II* that plaintiff's counsel must be sanctioned for

(continued next page)

The defendant again appealed, which resulted in *Gurary v. Winehouse*, 303 F. 3d 212 (2d Cir. 2002) (hereinafter "*Gurary III*").

In *Gurary III*, the Second Circuit held that the district court had erred in imposing sanctions equal to only half the defendant's legal fees. Despite the fact that the complaint had been determined to have been only half frivolous, and thus half not frivolous, the Second Circuit ruled that where there are both frivolous and non-frivolous claims in a complaint arising under the securities laws, the district court must evaluate the non-frivolous claims to determine whether they are of a "quality sufficient to make the suit as a whole nonabusive and the Rule 11 violation not substantial." *Gurary III*, 303 F.3d at 223. If the answer to this question is negative, the court held, then a presumption applies that the appropriate sanction is the full amount of reasonable legal fees incurred by the defendant.

The decision in *Gurary III* is directly contrary to and inconsistent with the decision of the Eleventh Circuit in *Oxford v. Jaharis*, 297 F.3d 1182 (11th Cir. 2002), decided about five weeks before *Gurary III*, which held that in the case of a complaint that is

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having asserted claims that the panel in *Gurary I* had found that the plaintiff was not asserting is simply inexplicable.

partially frivolous and partially not frivolous, the appropriate PSLRA sanction is the reasonable amount of legal fees incurred by the defendant in the defense of the frivolous claims only.

REASONS FOR GRANTING THE WRIT

THE DECISION OF THE SECOND CIRCUIT IN *GURARY III* CONFLICTS WITH THE DECISION OF THE ELEVENTH CIRCUIT IN *OXFORD V. JAHARIS*.

On July 16, 2002, about five weeks before the Second Circuit rendered its decision in *Gurary III*, the Eleventh Circuit decided *Oxford Asset Management, Ltd. v. Jaharis*, 297 F.3d 1182 (11th Cir. 2002) in which it addressed whether the PSLRA requires sanctions equal to the whole legal fee and disbursements, or just the portion attributable to frivolous claims. Other than *Oxford*, the *Gurary* trilogy, and the Second Circuit's Court's decision in *DeBartolo v. Richard Jacobs Group, Inc.* 186 F.3d 157 (2d Cir. 1999), petitioner is aware of no other appellate cases addressing the manner in which sanctions are to be determined under the PSLRA.

Since *Oxford* was decided shortly before the Second Circuit's decision in *Gurary III*, and the court in

Gurary III did not mention *Oxford* in its decision, plaintiff assumes that the panel was unaware of *Oxford*.

Oxford held that the PSLRA requires sanctions limited only to fees and disbursements incurred for the frivolous claims, and that fees or disbursements incurred defending non-frivolous claims are not properly part of a PSLRA sanctions award. *Oxford*, 297 F.3d at 1197.

Oxford approached the sanctions issue from a completely different perspective than this Court, holding that 15 U.S.C. §78u-4(c) and 15 U.S.C. § 77Z-1(c) "provide for a presumption that the proper sanction for a Rule 11(b) violation is an award, to the opposing party, of the reasonable attorney's fees and costs incurred as a direct result of the violation." *Oxford*, 297 F.3d at 1197.

Though the *Oxford* court did not elaborate on its thought process, we can deduce what appears to have been its thought process.

The *Oxford* court must have begun with the relevant section of the PSLRA which provides:

> (3) Presumption in Favor of Attorneys Fees and Costs.—
>
> (A) In general. Subject to subparagraphs (B) and (C), for purposes of

> paragraph (2), the court shall adopt a presumption that the appropriate sanction–
>
> (i) for failure of any responsive pleading or dispositive motion to comply with any requirement of Rule 11(b) of the Federal Rules of Civil Procedure is an award to the opposing party of the reasonable attorneys' fees and other expenses incurred as a direct result of the violation; and
>
> (ii) for substantial failure of any complaint to comply with any requirement of Rule 11(b) of the Federal Rules of Civil Procedure is an award to the opposing party of the reasonable attorneys' fees and other expenses incurred in the action.

15 U.S.C. § 78u-4(c)(3).

When confronted with the need to understand the ambiguous phrase "reasonable attorneys' fees and other expenses incurred in the action" used in § 78u-4(c)(3)(ii), the *Oxford* court evidently looked to the preceding subparagraph, § 78u-4(c)(3)(i), which governs sanctions on a defendant who mounts a frivolous defense, and interpreted § 78u-4(c)(3)(ii) governing sanctions on a plaintiff who brings a frivolous case in parallel with § 78u-4(c)(3)(i) applicable to a frivolous defense. Since § 78u-4(c)(3)(i) provides that a defendant who asserts a frivolous defense will

face sanctions equal to "the reasonable attorneys' fees and other expenses incurred as a direct result of the violation", the *Oxford* court apparently resolved the ambiguity of § 78u-4(c)(3)(ii) (as to sanctions for a partially frivolous complaint) by holding that the "direct result" standard also applies to plaintiffs who file a frivolous complaint, so that any sanctions will include only the fees incurred as a "direct result" of the frivolous claim.

The *Oxford* court's approach is patently fair, as it applies the same standard to plaintiffs as to defendants. There is no reason why a defendant asserting a frivolous defense should pay as sanctions only the legal fees incurred as a "direct result" of the violation, while a plaintiff asserting a frivolous claim should pay as sanctions the cost of defending the entire action, including the non-frivolous claims.

Oxford also appears to have limited the sanctions to the fees incurred in the district court, excluding the fees incurred on appeal. Though not discussed specifically, the matter was remanded with the sole instruction that the district court apportion the legal fee between frivolous and non-frivolous claims, with no indication that appellate costs were to be added on remand.

The *Oxford* approach is far sounder than the approach followed by the Second Circuit in *Gurary III*, as it sanctions only what is frivolous and thereby eliminates the effect that *Gurary III* undoubtedly will have of chilling ALL securities litigation; lawyers will be too afraid to assert even valid, non-frivolous securities claims since, under the Panel's decision, if part of the complaint is deemed frivolous the attorney may still have to personally pay the defendant's legal fees for defending against even the non-frivolous claims.

Essentially, the view expressed in *Gurary III* was that not including the legal fees generated seeking sanctions in a PSLRA sanctions award would lead some litigants not to seek PSLRA sanctions or to pursue them on appeal. *Gurary III* reasoned that Congress intended to encourage litigants in securities cases to seek sanctions, and so not allowing legal fees incurred in connection with seeking the sanctions to be part of the sanctions would be contrary to Congress' policy goals. Petitioner respectfully submits that this analysis on this point is erroneous.

The PSLRA requires that the district court, at the conclusion of a securities case, *sua sponte* review the complaint, responsive pleading, and any dispositive

motion, and make findings regarding compliance with Rule 11(b). 15 U.S.C. § 78u-4(c)(1).

The PSLRA provides an abbreviated mechanism for the determination of the appropriate amount of sanctions, so that far less work is required than in an ordinary Rule 11 motion, and there is a presumption in favor of sanctions awards. 15 U.S.C. § 78u-4(c)(2) and (c)(3)(A). There is a process involving submission of evidence, 15 U.S.C. § 78u-4(c)(3)(B), but the burden is on the party opposing sanctions, not the party seeking them. In sum, the PSLRA created an abbreviated sanctions procedure and a presumption regarding the amount of sanctions that in most cases will lead to higher sanctions than otherwise would have obtained under Rule 11 alone.

Petitioner believes that this is the extent of what Congress intended, and that Congress never intended for the PSLRA to become a new windfall source of revenue for securities defense lawyers.

Congress enacted the PSLRA in derogation of the common law rule that each side pays its own legal fees. Being in derogation of common law, the PSLRA must be strictly construed. *Thompson v. Thompson*, 218 U.S. 611 (1910).

The PSLRA provides that:

> upon final adjudication of the action, the court shall include in the record specific findings regarding compliance by each party and each attorney representing any party with each requirement of Rule 11(b) of the Federal Rules of Civil Procedure as to any complaint, responsive pleading, or dispositive motion.

15 U.S.C. § 78u-4(c)(1). The term "final adjudication" in context clearly means adjudication by the district court. This can be derived from the phrases that follow it. "The court shall include in the record" plainly suggests that this is a reference to district courts and not appellate courts since appellate courts generally do not add things to the record. And the phrase "compliance...with...Rule 11(b) of the Federal Rules of Civil Procedure" plainly suggests that this refers to the district court since the Federal Rules of Civil Procedure do not apply to the appellate courts.

Congress could have said "upon final adjudication of the action and at the conclusion of any appeal," but did not.

Congress clearly contemplated that any PSLRA sanctions award would be made at the conclusion of the case at the district court level, not at the appellate

level, and as such would include only legal fees incurred in the district court. As *Gurary III* noted, the legislative history of the PSLRA was grounded in a perception that Rule 11 was not strong enough to be an effective deterrent of frivolous securities cases. Rule 11 is part of the FRCP, which govern procedure only in the district courts and are not applicable to the appellate courts. Sanctions at the appellate level are governed by Rule 38 of the Federal Rules of Appellate Procedure ("FRAP"). Nothing in the text of the PSLRA, its legislative history, or in any decision applying the PSLRA suggests that Congress made any finding that FRAP Rule 38 needed to be strengthened, or that Congress ever intended for the PSLRA to govern appellate proceedings. The PSLRA refers to Rule 11, not FRAP Rule 38. Thus, by its own terms, it applies only to district court proceedings.

The usual practice in the federal appellate courts is for the appellate court to impose sanctions under FRAP Rule 38 if the appeal was frivolous. There is no indication that Congress intended to change this, or that Congress meant to inhibit genuine, good faith, non-frivolous appellate practice, or to inhibit attorneys from bringing good faith appeals from sanctions awards.

Whatever can be said about the merits of the underlying complaint, there is no question that the plaintiff's appeals in this case were good faith appeals. This is shown by the three lengthy opinions in *Gurary I, II, and III*. The question of whether or not sanctions were required under the PSLRA and what those sanctions should be was unquestionably close, and the plaintiff's position on these issues cannot be described as "frivolous." While this Court did ultimately rule in *Gurary II* that part of the complaint was frivolous and that a sanctions award was required under the PSLRA, the district court had twice denied such a sanctions award, and in *Gurary III* the Second Circuit again remanded on the issue of sanctions. Application of the PSLRA had never been addressed by the Second Circuit, and was sufficiently complex to generate a 31 page opinion plus a 13 page concurrence in just *Gurary III*, in addition to the many pages devoted to *Gurary I* and *II*.

Since the petitioner's opposition to Nu-Tech's sanctions application clearly was not frivolous, there is no basis under the PSLRA for any award of sanctions to include the legal fees that were incurred by the defendant applying for sanctions.

CONCLUSION

The PSLRA is a new statute that has not yet received much appellate review. The only two cases that have addressed these two points are *Gurary* and *Oxford.* The Second Circuit's decision in *Gurary III* and the Eleventh Circuit's decision in *Oxford* were handed down within five weeks of each other, yet are irreconcilable.

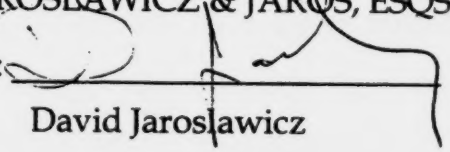
In order to give proper guidance to the Bar so that practitioners in the important field of securities litigation—now more important than ever in recent memory in the aftermath of the Enron and Worldcom debacles—will know how to guide their conduct to avoid sanctions, rather than being caught in a stark dichotomy between the Second and Eleventh Circuits, petitioner respectfully submits that a writ of certiorari is warranted.

For the reasons set forth herein, petitioners respectfully request that this Court grant a writ of certiorari to the United States Court of Appeals for the Second Circuit.

Dated: New York, New York
January 13, 2003

Respectfully submitted,

JAROSLAWICZ & JAROS, ESQS.

By: 

David Jaroslawicz

150 William Street, 19th floor
New York, New York 10038
(212) 227-2780

Of counsel:
David Jaroslawicz,
Robert J. Tolchin.

Appendix

Appendix A

Decision And Order Of The District Court Dated February 10, 1998 Dismissing Plaintiff's Complaint

UNITED STATES DISTRICT COURT

FOR THE SOUTHERN DISTRICT OF NEW YORK

MORDECHAI GURARY,

Plaintiff,

-against-

ISAAC WINEHOUSE d/b/a WALL & BROAD EQUITIES and NU-TECH BIO-MED, INC,

Defendants.

97 Civ. 3803 (LLS)

February 9, 1998, Decided
February 10, 1998, Filed

LOUIS L. STANTON, U.S.D.J.:

Mr. Gurary sues Isaac Winehouse and Isaac Winehouse d/b/a Wall & Broad Equities under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, as well as § 349 of New York General Business Law, claiming

he was injured by a scheme to manipulate the market for shares of Nu-Tech Bio-Med, Inc. ("Nu-Tech"). He sues Nu-Tech under the same laws, claiming that Nu-Tech knew of the scheme but did not disclose it. He seeks to enjoin Nu-Tech, pending the determination of this action, from registering the Convertible Stock referred to below. Defendants move to dismiss all claims.

Plaintiff alleges that in November of 1996, Nu-Tech privately issued 14,000 shares of "Series A Convertible Preferred Stock" for a total price of $14 million. Compl. ¶¶ 16, 21. The stock was convertible, at a later date, into common stock at the lesser of $17.50 per share or 75% of the average closing price for the five trading days prior to conversion. Compl. ¶ 19. Plaintiff claims that Winehouse and "other members of his cartel" arranged to buy a large part of the Convertible Stock using the names "of other nominees who were not really the owners of the stock." Compl. ¶ 23. He alleges that the Winehouse cartel then began selling the stock short using various accounts to conceal the identities of its members. Compl. ¶ 26. Their purpose was to manipulate the market and drive down the price of Nu-Tech shares. Compl. ¶ 40.

Plaintiff says that in December of 1996, Marvin Feigenbaum, the Chairman of Nu-Tech, found out

about Winehouse's scheme and called Winehouse demanding that he stop, or that Nu-Tech would not permit the registration of the Convertible Stock to become effective. Compl. ¶¶ 27-28. Although the stock price did not drop over the next two months, the short sales continued and at a meeting on February 18, 1997, Feigenbaum proposed that Winehouse stop his activities in exchange for a 10% profit on the amount paid for the Convertible Stock "and that the short sellers would be permitted to keep their profits." Compl. ¶ 29. Winehouse rejected the offer and stated that he would continue his short-selling. Compl. ¶ 34. Over the next two days, the price of the stock dropped approximately six dollars per share. Compl. ¶ 35. Plaintiff alleges that as a result of the cartel's fraudulent conduct, he purchased Nu-Tech stock at artificial prices and incurred substantial losses. Compl. ¶ 42. He also claims that for failing to notify the public of Winehouse's scheme, Nu-Tech's conduct "constituted fraud with respect to concealing material information and providing misinformation." Compl. ¶ 49.

Gurary's suit is based on four Nu-Tech purchases, two of which he made before the cartel allegedly started manipulating the market. Compl. ¶¶ 13, 16, 24.

Dealing with those trades first, the plaintiff cannot rest a claim on the two purchases completed before the short-selling began, because the scheme was not "in connection with" those purchases. "Where the only manipulative or deceptive acts identified in a complaint occur after a challenged securities purchase or sale, a court must dismiss the complaint as failing to state a cause of action for federal securities fraud." *Samuel M. Feinberg Testamentary Trust v. Carter*, 652 F. Supp. 1066, 1080 (S.D.N.Y. 1987). The prices paid for his first two purchases were unaffected by the claimed manipulation.

The claims regarding plaintiff's last two purchases of stock (which took place during the alleged manipulation) fail for lack of reliance upon any but the true picture. In response to defendants' motions to dismiss, Gurary submitted his affidavit stating:

> When Nu-Tech stock started to decline, I, as other shareholders of Nu-Tech, became concerned. I personally spoke to Marvin Feigenbaum, the president of Nu-Tech, in or about December, 1996—I do not recall the exact date—and he advised me that he had spoken to Isaac Winehouse, the defendant in this case, as well as to Mr. Winehouse's counsel, Heller, Horowitz & Feit, P.C. and alerted them that if the Winehouse group did

not stop shorting Nu-Tech stock, he would withdraw the registration of those shares so that the group, rather than being assured of a locked-in profit, would have to buy the stock in the open market at possibly higher prices and that this would convince them not to continue shorting the stock.

I continued to buy Nu-Tech stock, buying one thousand shares on December 24, 1996 at 11-3/4.

Affidavit of Mordechai Gurary, sworn to August 20, 1997, at p. 3. Gurary testifies about his final purchase:

On or about February 18, 1997, I again spoke to Marvin Feigenbaum, president of Nu-Tech, who advised me that a meeting had been held that day at Nu-Tech's offices [with Mr. Winehouse].

At the meeting on February 18, 1997, Mr. Feigenbaum had requested Mr. Winehouse and his group, which members Mr. Winehouse refused to identify, to stop shorting Nu-Tech stock [in exchange for the 10% premium and retaining of profits explained earlier in this opinion]...

According to Mr. Feigenbaum, Mr. Winehouse refused to agree to this but instead advised Mr. Feigenbaum that it was not to Mr. Winehouse's personal benefit to

> resolve the dispute on those terms and he would see to it that Mr. Feigenbaum did not have a future in the company—because his options at $7 and $11.50 would be worthless, to which Mr. Feigenbaum responded that, if necessary he would get his option plan reissued at $1. Mr. Winehouse also said he would see to it that the price of Nu-Tech stock would fall significantly.
>
> Mr. Feigenbaum further advised me that the Board of Directors had designated Robert Fagenson and one other Board member to negotiate with Mr. Winehouse and the Reg. D holders.
>
> Mr. Feigenbaum further advised me that the company would not give in to Mr. Winehouse's blackmail and would refuse to register the short-sellers' shares.
>
> I then purchased another 8,350 shares of Nu-Tech stock on February 18, 1997 at 11-9/16.

Id., at ¶¶. 4-5.

Mr. Gurary does not claim that any of Mr. Feigenbaum's statements to him were false when they were made. Gurary was fully informed by Feigenbaum and cannot rely on any omission by Nu-Tech in connection with the purchase of those securities. Nor can plaintiff's claims succeed on a "fraud on the

market" theory, because while there is presumption of reliance, defendants may show:

> that an individual plaintiff traded or would have traded despite his knowing the statement was false. Any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance.

Basic Inc. v. Levinson, 485 U.S. 224, 248, 108 S. Ct. 978, 992, 99 L. Ed. 2d 194 (1988). Here, the link is severed because plaintiff "actually knew the information that was not disclosed to the market." *Fine v. American Solar King Corp.*, 919 F.2d 290, 299 (5th Cir. 1990) (citing *Basic Inc.*, 485 U.S. at 248, 108 S. Ct. at 992). Defendants are awarded summary judgment dismissing the securities fraud claims.[1]

Plaintiff's remaining claims are based on N.Y. Gen. Bus. Law § 349. The general rule is that where "all federal-law claims are eliminated before trial, the balance of factors to be considered under the pendent

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[1] I express no opinion concerning the availability or merit of any other relief, through private or regulatory agency action, concerning the short-sale transactions.

jurisdiction doctrine...will point toward declining to exercise jurisdiction over the remaining state-law claims." *Carnegie-Mellon Univ. v. Cohill,* 484 U.S. 343, 350 n.7, 108 S. Ct. 614, 619 n.7, 98 L. Ed. 2d 720 (1988). The state claims are therefore dismissed without prejudice.

Since no claims remain in this court, the application for an injunction *pendente lite* is denied.

CONCLUSION

Defendants' motion is granted. The application for an injunction is denied. The Clerk will enter judgment dismissing the complaint, without prejudice to plaintiff's state-law claims.

So ordered.

Dated: New York, New York
February 9, 1998

S/
LOUIS L. STANTON
U.S.D.J.

Appendix B

Decision Of Second Circuit In Gurary I Affirming Dismissal And Remanding For PSLRA Findings Of Compliance With Rule 11

Nos. 98-7239(L), 98-7280(XAP)

MORDECHAI GURARY

Plaintiff-Appellant-Cross-Appellee,

v.

ISAACWINEHOUSE and ISAAC WINEHOUSE, doing business as Wall & Broad Equities,

Defendant- Appellee

v.

NU-TECH BIO-MED, INC.

Defendant- Appellee-Cross-Appellant.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

ARGUED OCTOBER 6, 1998

DECIDED AUGUST 24, 1999

OPINION OF THE COURT

Before: WALKER, Circuit Judge, OAKES, Senior Circuit Judge, and KAPLAN, District Judge. *

* Honorable Lewis A. Kaplan, United States District Judge for the Southern District of New York, sitting by designation.

KAPLAN, District Judge:

Plaintiff appeals from a judgment of the district court (Stanton, J.) to the extent that it dismissed the plaintiff's claims under Section 10(b) of the Securities and Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78j, and Rule 10b-5 thereunder on the merits and his pendent state claims for lack of subject matter jurisdiction. One of the defendants cross-appeals from so much of the judgment as denied so much of its motion as sought sanctions under the Private Securities Litigation Reform Act of 1995 (the "PSLRA"). We affirm so much of the judgment as dismissed plaintiff's case. We vacate and remand insofar as it denied the application for sanctions.

I

Nu-Tech Bio-Med, Inc.("Nu-Tech") was formed in 1981. Its common stock, which is the security that allegedly was manipulated, is traded on NASDAQ.

THE NU-TECH CONVERTIBLE PREFERRED

In late 1996,[1] at a time when Nu-Tech common stock was trading at about $15 per share, Nu-Tech raised $14 million by issuing 14,000 shares of Series A Convertible Preferred Stock in a private placement at a price of $1,000 per share. This security had no voting rights and paid no dividends but was convertible into common at the lesser of (1) $17.50 per share, and (2) 75 percent of the average closing bid price of the common for the five trading days prior to the date of the holder's notice of conversion, with one-third of the holder's shares being convertible on each of the forty-fifth, the seventy-fifth, and the one hundred-fifth day after issuance. Nu-Tech was obliged to register the common stock into which the preferred was convertible. These characteristics had several notable implications.

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[1] The complaint alleges that the initial issue date was November 6, 1996. A registration statement for a subsequent sale of common stock states that the placement was completed on December 2, 1996.

First, the facts that the preferred (a) paid no dividends, (b)had no voting rights, and (c) was convertible to common at a bargain price, and that (d) the conversion right expired following the one hundred fifth day following issuance meant that the preferred almost inevitably would be converted.[2]

Second, purchasers of the preferred were likely to profit no matter what happened to the price of the common stock, provided only that the company survived. If the common traded below $23.33 per share immediately prior to conversion, the preferred would be converted at 75 percent of the price of the common (which would be less than $17.50). As long as the price of the common did not fall more than 25 percent following the conversion, the preferred shareholder would profit by conversion and sale of the common into which the preferred was converted.[3] If the common traded above $23.33 immediately prior to conversion, the preferred would be converted at $17.50 (which

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[2] In addition, Nu-Tech had the right to force conversion commencing 270 days following the completion of the private placement.

[3] For example, if the common continued to trade at its preconversion price, but at any price below $23.33, the preferred shareholder would gain a constant $333.33 per share by converting and selling the newly issued common.

would be less than 75 percent of the trading price of the common), thus virtually assuring an even greater profit.

Third, even if the preferred were to be converted into the minimum number of common shares,[4] the preexisting common stock holders would be diluted very substantially. At the minimum conversion ratio of 57.14 shares of common per share of preferred, conversion of the entire issue of preferred would result in the issuance of 799,970 additional shares of common, whereas Nu-Tech had only about 2.4 million shares outstanding at the time of the private placement. Conversion at higher ratios (i.e., when the price of the common was below $23.33 per share) would increase the number of shares issued and therefore the dilution. Indeed, a sufficiently substantial drop in the price of the common could increase the conversion ratio so much that conversion would result in the former preferred shareholders owning a majority of the company's post-conversion common stock. Thus, the existence of the convertible preferred, in and of itself, doubtless exerted downward pressure on the price of the common.

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[4] The conversion price of the lower of $17.50 or 75 percent of the trading price of the common meant that the number of

(continued next page)

WINEHOUSE'S ALLEGED SCHEME

The complaint alleges that defendant Isaac Winehouse, doing business as Wall & Broad Equities, organized a "cartel" to purchase a percentage of the Nu-Tech convertible preferred in the names of nominees. He then allegedly arranged for a number of securities firms to become market makers in Nu-Tech common stock and proceeded to sell the common short, allegedly to drive the price of the common stock down.

THE DEALINGS AMONG NU-TECH, WINEHOUSE AND PLAINTIFF

Plaintiff Mordechai Gurary purchased 1,000 shares of Nu-Tech common on October 31, 1996 and another 5,500 shares on November 7, 1996 at $14.60 and $15.50 per share, respectively. In or about December 1996, the stock price began to decline. A concerned Gurary spoke to J. Marvin Feigenbaum, chairman of Nu-Tech. Feigenbaum told him that he had spoken to Winehouse and threatened that Nu-Tech would refuse to register the common stock into which the preferred was convertible unless Winehouse and his group stopped shorting the common. He predicted that this

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shares into which each share of preferred was convertible could not fall below 57.14.

threat would convince Winehouse to stop shorting the stock because a refusal to register the common issued upon conversion would force Winehouse to cover his short position by purchasing Nu-Tech common in the open market, perhaps at higher prices. Gurary, evidently comforted, then purchased another 1,000 shares on December 24, 1996 at a price of $11.75 per share.

Gurary claims subsequently to have learned that Winehouse and his associates had continued to short the stock using nominee names, having arranged to "borrow" an unlimited number of shares for that purpose from market makers. On February 18, 1997, Gurary again spoke to Feigenbaum, who told him that he had met that day with Winehouse and others in another attempt to stop the short selling. Feigenbaum told Gurary that Nu-Tech had offered to repurchase the group's preferred shares at cost plus ten percent and to allow it to keep its existing profits from the short sales if the group would stop its activities but that Winehouse had refused. Feigenbaum, however, told Gurary that Nu-Tech would not give in to Winehouse and would refuse to register the short sellers' shares. Later that day, Gurary bought another 8,350 shares of Nu-Tech common at a price of $11.57.

On March 12, 1997, Feigenbaum and another Nu-Tech board member met again with Winehouse and asked that Winehouse and his group accept registration of the common stock into which their preferred was convertible over a period of twelve months rather than insisting that it be registered immediately. Winehouse again refused and said that he would continue to sell short.

Nu-Tech common stock dropped approximately $6 per share over the next two days. On March 14, 1997, the company issued a press release which stated that the price decline could be attributed to "possible sales by shareholders." No mention was made of the discussions between Nu-Tech and Winehouse, allegedly to avoid disrupting Nu-Tech's efforts to acquire Physicians Clinical Laboratory, Inc. ("PCL") out of bankruptcy.

A few days later, Gurary was approached through an intermediary and spoke with Winehouse, who allegedly admitted to him that he deliberately had shorted the stock to drive the price down, said that he intended to continue, and advised Gurary to sell his shares because the price would drop to "a dollar."

PROCEEDINGS BELOW

Plaintiff commenced this action against Nu-Tech and Winehouse on May 23, 1997. The complaint contains three relevant claims for relief.[5] The first charges Winehouse with manipulation of Nu-Tech's common stock in violation of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j, and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5, by the purchase of the convertible preferred and the shorting of the common.[6] The second claim is against Nu-Tech and charges a 10b-5 violation in that Nu-Tech, motivated by a desire to avoid having Winehouse and other short

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[5] The fourth claim for relief sought a preliminary injunction barring Nu-Tech from registering the convertible preferred pending the determination of the action. Plaintiff, however, never moved for a preliminary injunction. Moreover, the complaint alleges that the convertible preferred was issued in December 1996 in a private placement subject to Regulation D under the Securities Act of 1933, 15 U.S.C. § 77a et seq. (the "Securities Act"). In consequence, the issuance of the convertible preferred was exempt from registration. 15 U.S.C. § 77d(2); 17 C.F.R. §§ 230.501-08 (1998).

[6] It charges also that "the defendants made numerous misstatements of material facts and omissions to state material facts necessary in order to make statements not misleading." As it does not identify any such misstatements or omissions in the first claim for relief, this aspect of the complaint fails to comply with FED. R. CIV. P. 9(b) and may be disregarded.

sellers object to its effort to acquire certain debt securities of PCL in a transaction requiring bankruptcy court approval, "failed to reveal the sale to Winehouse and his group through the use of nominees, that there were meetings going on between Winehouse and his group and Nu-Tech; that Nu-Tech was aware of the short-selling by Winehouse and his group; [and] that Nu-Tech would refuse to register certain stocks due to the short-selling activities of Winehouse and his group..." In addition, it charges that Nu-Tech's March 14, 1997 press release was misleading for failure to disclose Winehouse's short sales and the discussions between Nu-Tech and Winehouse. The third claim for relief alternatively seeks recovery from both defendants under Section 349 of the New York General Business Law.

Both defendants moved to dismiss the complaint for failure to state a claim upon which relief may be granted. Gurary opposed the motions and submitted a nine page affidavit in which he recounted his conversations with Messrs. Feigenbaum and Winehouse in greater detail than was included in the complaint. His attorney also submitted an argumentative affidavit that claimed no personal knowledge of anything relevant to the case, but that

suggested that Winehouse had violated Section 5 of the Securities Act, 15 U.S.C. § 77e.

In disposing of the motions, Judge Stanton specifically relied upon Gurary's affidavit, thus converting them into motions for summary judgment pursuant to Rule 12(b). He noted that the case was based on four purchases of Nu-Tech common stock by Gurary, two of which preceded the alleged commencement of the short selling and the other two of which were made after Gurary learned of the short sales from Feigenbaum. He therefore dismissed the Rule 10b-5 claim against Winehouse with respect the first pair of purchases on the ground that Winehouse's allegedly manipulative short sales were not made "in connection with" those purchases. He dismissed the 10b-5 claim based on the second pair of purchases on the ground that plaintiff's knowledge of the facts defeated any claim "of reliance upon any but the true picture." He dismissed the Rule 10b-5 claim against Nu-Tech because the complaint failed to allege that any of Feigenbaum's statements to plaintiff was false when made. Having held the federal claims insufficient, Judge Stanton dismissed the state law claims for lack of subject matter jurisdiction. Judgment was entered accordingly.

Plaintiff appeals from the judgment. Nu-Tech cross-appeals insofar as the district court failed to grant sanctions against plaintiff pursuant to the PSLRA, 15 U.S.C. § 78u-4 et seq.

II

Plaintiff argues first that the district court erred by considering his own affidavit and thus converting the motions into motions for summary judgment. Having done so, he contends, the court erred further by deciding them without giving the plaintiff an opportunity to conduct discovery.

CONVERSION OF THE MOTION

Rule 12(b) provides in relevant part:

> "If, on a motion asserting the defense numbered (6) to dismiss for a failure of the pleading to state a claim upon which relief can be granted, matters outside the pleading are presented to and not excluded by the court, the motion shall be treated as one for summary judgment and disposed of as provided in Rule 56, and all parties shall be given reasonable opportunity to present all material made pertinent to such a motion by Rule 56."

We frequently have held that a district court ordinarily must give notice to the parties before converting a motion to dismiss pursuant to Rule 12(b)(6) into one for summary judgment and considering matters outside the pleading. *E.g., Kopec v. Coughlin,* 922 F.2d 152, 154-55 (2d Cir. 1991). This is simply an application, however, of the principle that parties are entitled to a reasonable opportunity to present material pertinent to a summary judgment motion. Hence, "compliance...is not an end in itself. * * * The essential inquiry is whether the appellant should reasonably have recognized the possibility that the motion might be converted into one for summary judgment or was taken by surprise and deprived of reasonable opportunity to meet facts outside the pleadings." *In re G. & A. Books, Inc.,* 770 F.2d 288, 295 (2d Cir. 1985), cert. denied sub nom. *M.J.M. Exhibitors, Inc. v. Stern,* 475 U.S. 1015, 89 L. Ed. 2d 310, 106 S. Ct. 1195 (1986).

In this case, it was plaintiff who submitted the affidavit relied upon by the district court and who thus invited Judge Stanton to rely not only on the complaint, but upon the more elaborate explication of plaintiff's grievance contained in his affidavit. He certainly cannot be heard to claim that he was surprised when the district court accepted his invitation. Indeed, the district

court arguably would have erred in declining to do so. *See Freeman v. Marine Midland Bank,* 494 F.2d 1334, 1338-39 (2d Cir. 1974) (error to disregard affidavits submitted by plaintiff in opposition to a motion to dismiss). In consequence, the motions properly were converted.

RULE 56(f)

Plaintiff's claim that the court below erred in deciding the motions without giving him an opportunity to conduct discovery also lacks merit.

Rule 56(f) provides:

> "Should it appear from the affidavits of a party opposing the motion that the party cannot for reasons stated present by affidavit facts essential to justify the party's opposition [to a motion for summary judgment], the court may refuse the application for judgment or may order a continuance to permit affidavits to be obtained or depositions to be taken or discovery to be had or may make such other order as is just."

Thus, as we often have said, a party resisting summary judgment on the ground that it needs discovery in order to defeat the motion must submit an affidavit showing "'(1) what facts are sought [to resist the motion] and how they are to be obtained, (2) how

those facts are reasonably expected to create a genuine issue of material fact, (3) what effort affiant has made to obtain them, and (4) why the affiant was unsuccessful in those efforts.'" *Meloff v. New York Life Ins. Co.*, 51 F.3d 372, 375 (2d Cir. 1995) (quoting *Hudson River Sloop Clearwater, Inc. v. Department of Navy*, 891 F.2d 414, 422 (2d Cir. 1989)); accord, *Paddington Partners v. Bouchard*, 34 F.3d 1132, 1137-38 (2d Cir. 1994); *Burlington Coat Factory Warehouse Corp. v. Esprit De Corp.*, 769 F.2d 919, 926 (2d Cir. 1985). Indeed, the failure to file such an affidavit is fatal to a claim such as plaintiff makes here even if the party resisting the motion for summary judgment alluded to a claimed need for discovery in a memorandum of law. *Paddington Partners*, 34 F.3d at 1137.

The affidavits plaintiff submitted in the district court did not contend that any discovery was required to meet the defendants' motions, let alone satisfy the test articulated most recently in *Meloff*. Indeed, plaintiff did not even hint below at any need for discovery in order to resist defendants' motions. In consequence, the court below plainly did not err in passing on the merits of the motions in the absence of any discovery.

III

Plaintiff's attack on the dismissal of his Rule 10b-5 claim against Nu-Tech is limited to the claim that he was deceived in making his December 24, 1996 and February 18, 1997 purchases because he relied upon Feigenbaum's declarations that Nu-Tech would not register the common into which the Winehouse group's preferred was convertible and that this should or would stop it from selling the common short.[7] But this argument too is without merit.

To begin with, this theory is not the basis of the Rule 10b-5 claim against Nu-Tech set forth in the complaint and in Gurary's affidavits, which in essence was that Nu-Tech had failed to disclose what it knew of Winehouse's activities. While the papers described Gurary's alleged conversations with Feigenbaum, the articulated grievance against Nu-Tech was its alleged concealment of the short-selling activities, allegedly in order to protect its efforts to buy PCL. Having failed to make the present argument to the district court, plaintiff will not be heard to advance it here. *E.g., Mycak*

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[7] Appellant's Brief ("App. Br.") 29-30. He thus has abandoned any other claims against Nu-Tech, including the contention that the March 14, 1997 press release was misleading.

v. Honeywell, 953 F.2d 798, 803 (2d Cir. 1992); *Schmidt v. Polish People's Republic*, 742 F.2d 67, 70 (2d Cir. 1984). Even if the argument were properly before us, however, it would lack merit.

It is important to recognize that plaintiff's contention with respect to his pivotal conversations with Feigenbaum is that Feigenbaum allegedly stated that Nu-Tech would block the registration of the common. He spoke in the future tense. The statements therefore were ones of intention or of a promissory nature.

In order to state a claim under Rule 10b-5, the plaintiff must "allege material misstatements or omissions indicating an intent to deceive or defraud in connection with the purchase or sale of a security." *Luce v. Edelstein*, 802 F.2d 49, 55 (2d Cir. 1986) (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 47 L. Ed. 2d 668, 96 S. Ct. 1375 (1976)). "The failure to carry out a promise made in connection with a securities transaction is normally a breach of contract. It does not constitute fraud unless, when the promise was made, the defendant secretly intended not to perform or knew than he could not perform." *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1176 (2d Cir. 1993).

Here, there is no suggestion in the complaint or in Gurary's affidavit that Feigenbaum did not intend to

do just what he promised at the times he made the statements to which Gurary now points. In consequence, the claim now advanced against Nu-Tech is fundamentally flawed. The complaint was properly dismissed against the corporate defendant.

IV

We come now to the manipulation claim against Winehouse.

THE FINAL PURCHASES

Plaintiff's last two purchases of Nu-Tech shares, which occurred on December 24, 1996 and February 18, 1997, are readily disposed of. He made each just after speaking with Feigenbaum concerning Winehouse's short selling and having been told that Nu-Tech would refuse to register the common into which Winehouse's preferred was convertible, thus preventing him from covering his short position with newly issued common and thereby perhaps deterring further short selling. In consequence, Gurary made each of these purchases in the belief that the prices he paid reflected Winehouse's allegedly manipulative activities.

The gravamen of manipulation is deception of investors into believing that prices at which they

purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators. *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 12, 86 L. Ed. 2d 1, 105 S. Ct. 2458 (1985). In order to make out a 10b-5 claim, moreover, the plaintiff must allege and prove, among other elements, reliance. *E.g., Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 52 (2d Cir. 1995). In consequence, a private plaintiff in such a case must establish that he or she engaged in a securities trade in ignorance of the fact that the price was affected by the alleged manipulation. *See Ray v. Lehman Brothers Kuhn Loeb, Inc.*, 624 F. Supp. 16, 19 (N.D. Ga. 1984) (plaintiff in § 9(e) manipulation case must show reliance on false appearance of actual or apparent trading). By plaintiff's own admission, this requirement is not satisfied with respect to these two purchases. Judge Stanton therefore correctly dismissed his claim based upon them.

THE INITIAL PURCHASES

Plaintiff's initial purchases of Nu-Tech shares were made on October 31 and November 7, 1996. The alleged manipulation is said to have begun "following [the Winehouse group's] acquisition of a large part of the...Series A Convertible Preferred..." (Cpt ¶ 24)

The district court's dismissal of the claim based on the first purchase was correct. Gurary concedes that the alleged manipulation did not begin until at least November 6, 1996. In order to make out a claim under Rule 10b-5, however, the plaintiff must allege culpable deception "in connection with the purchase or sale of a security..." *E.g., Acito,* 47 F.3d at 52. Quite clearly, any deception inherent in the execution of a manipulative scheme beginning on or after November 6 was not "in connection with" plaintiff's purchase on October 31. *See, e.g., Samuel M. Feinberg Testamentary Trust v. Carter,* 652 F. Supp. 1066, 1080 (S.D.N.Y. 1987).

The matter is not so clear with respect to the second purchase. The complaint alleges that the "initial issue date" of the preferred was November 6, 1996 (Cpt ¶ 21), the day prior to plaintiff's second purchase. In consequence, if one were to assume that the Winehouse group acquired its preferred stock on November 6 and, as the complaint alleges, that the manipulation began "following the acquisition" of the preferred, the November 7 purchase might have been made at the very start of the alleged manipulation. Plaintiff therefore argues that the district court erred in dismissing his claim based on the second purchase because there was an issue of fact as to whether the

alleged manipulation began after the second purchase. But this contention is insufficient to save the complaint.

Viewing the complaint in the light most favorable to plaintiff, he alleges that the scheme to depress the stock began on the day prior to or the very day of the plaintiff's November 7 purchase. The price at which plaintiff purchased on that date, he alleges, was $15.50—90 cents per share or 6.2 percent higher than his previous purchase, which concededly antedated the start of the attempt to drive the stock down. But we need not assume that the price plaintiff paid on November 7 was not affected by any short selling, likely as that seems, as the very fact that Gurary was a buyer in a market allegedly depressed by a manipulative scheme is an insurmountable obstacle to his claim based on that purchase.

If Winehouse actually did depress the price of the shares on November 7, plaintiff benefited from that price decline by purchasing at a lower price than he otherwise would have pa*id.* As a general matter, a defrauded buyer is entitled under Rule 10b-5 to recover "only the excess of what he paid over the value of what he got." *Levine v. Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971) (Friendly, J.); *accord, e.g., Elkind v. Liggett & Myers,*

Inc., 635 F.2d 156, 168 (2d Cir. 1980).[8] Where, as here, a buyer pays less for a security by reason of a defendant's fraud or manipulation, there is no excess of price over value, so the buyer may not recover. Indeed, that is no more than a common sense application of Section 28(a) of the Exchange Act, which provides that "no person permitted to maintain a suit for damages under the provisions of this chapter shall recover...a total amount in excess of his actual damages on account of the act complained of." 15 U.S.C. § 78bb(a). Moreover, it would be anomalous indeed to permit a plaintiff to recover damages where the characteristic that made the conduct complained of unlawful, here the allegedly artificial depression of the price, worked to plaintiff's benefit. *See Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 50 L. Ed. 2d 701, 97 S. Ct. 690 (1977) (plaintiff claiming injury caused by enhanced

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[8] To the extent that it suggested that a defrauded buyer never may recover on a benefit-of-the-bargain theory, Levine was dictum. *See e.g., McMahan & Co. v. Wherehouse Entertainment, Inc.*, 65 F.3d 1044, 1048 (2d Cir. 1995), cert. denied, 517 U.S. 1190, 134 L. Ed. 2d 781, 116 S. Ct. 1678 (1996); *Commercial Union Assur. Co. v. Milken*, 17 F.3d 608, 614-15 (2d Cir.), cert. denied, 513 U.S. 873, 130 L. Ed. 2d 130, 115 S. Ct. 198 (1994); *Barrows v. Forest Labs., Inc.*, 742 F.2d 54, 59-60 (2d Cir. 1984); *Osofsky v. Zipf*, 645 F.2d 107, 111-12 (2d Cir. 1981). That qualification, however, has no bearing in this case.

competition resulting from merger lacked standing to sue for damages on theory that merger violated antitrust laws because alleged injury not caused by that which allegedly rendered merger unlawful).[9]

Section 10(b) and Rule 10b-5 prohibit fraud only "in connection with" the purchase and sale of securities. Accordingly, only a purchaser or seller may sue thereunder. *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 44 L. Ed. 2d 539, 95 S. Ct. 1917 (1975). Plaintiff nowhere alleges that he sold any shares. To whatever extent that he seeks compensation for the decline in the price of Nu-Tech shares caused by allegedly manipulative short sales in the period following his purchases, the loss was not the product of fraud in connection with the purchase or sale of securities by Gurary and therefore is not recoverable. *See Blue Chip Stamps*, supra, 421 U.S. at 737-38 (decline in value of stock allegedly held in consequence of fraudulent statement not recoverable); *Birnbaum v.*

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[9] Plaintiff alleges also that the price of Nu-Tech common later fell, ultimately to about $2 per share by the time suit was filed in May 1997. It is not entirely clear from the complaint that he seeks to recover for that decline, as his grievance seems to be that he purchased at prices artificially affected by the alleged manipulation. (Cpt P 42) In any case, however, plaintiff may not

(continued next page)

Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956, 96 L. Ed. 1356, 72 S. Ct. 1051 (1952) (same); *see also First Equity Corp. v. Standard & Poor's Corp.*, 869 F.2d 175, 180 n.2 (2d Cir. 1989) (10b-5 plaintiffs "may recover only for losses that result from decisions to buy or sell, not from decisions to hold or refrain from trading"); *Elkind*, 635 F.2d at 170-71 (defrauded buyer could not recover for subsequent price decline because not "in connection with" the purchase); *Abrahamson v. Fleschner*, 568 F.2d 862, 868 (2d Cir. 1977), cert. denied, 436 U.S. 905, 436 U.S. 913, 56 L. Ed. 2d 414, 98 S. Ct. 2253 (1978) ("requirement of fraud in connection with the purchase or sale of a security is not satisfied by an allegation that plaintiffs were induced fraudulently not to sell their securities").

V

Finally, we turn to Nu-Tech's cross-appeal from the denial of its motion for sanctions pursuant to Section 21D of the Exchange Act, as added and amended by the PSLRA, 15 U.S.C. § 78u-4.

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recover for the decline in the price of his holdings subsequent to his purchases.

Section 21D(c)(1), 15 U.S.C. § 78u-4(c)(1), provides in relevant part that, upon final adjudication of any private action arising under the Exchange Act, "the court shall include in the record specific findings regarding compliance by each party and each attorney representing any party with each requirement of Rule 11(b) of the Federal Rules of Civil Procedure as to any complaint, responsive pleading, or dispositive motion." If the court finds such a violation, "the court shall impose sanctions," although only after giving the party or attorney involved notice and an opportunity to respond. *Id.* § 78(c)(2).

In this case, Nu-Tech moved for the imposition of sanctions pursuant to this statute. Although the judgment implicitly denied Nu-Tech's motion, the district court made no findings regarding compliance with Rule 11(b). As the statute required the district court to make findings, we have no choice but to remand in order to permit it to do so.

VI

The judgment appealed from is affirmed insofar as it granted summary judgment dismissing the

complaint[10] but vacated insofar as it denied Nu-Tech's motion for sanctions. The case is remanded with respect to sanctions for further proceedings consistent with this opinion.

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[10] The district court's dismissal of the state law claims for lack of jurisdiction once it correctly dismissed the federal claims was entirely appropriate. *See* 28 U.S.C. § 1367(c)(3).

Appendix C

Decision And Order Of The District Court Dated January 12, 2000 Finding No Violation Of Rule 11 And Denying Request For Sanctions

UNITED STATES DISTRICT COURT

FOR THE SOUTHERN DISTRICT OF NEW YORK

MORDECHAI GURARY,

Plaintiff,

-against-

ISAAC WINEHOUSE d/b/a WALL & BROAD EQUITIES and NU-TECH BIO-MED, INC,

Defendants.

97 Civ. 3803 (LLS)

January 12, 2000, Decided
January 12, 2000, Filed

LOUIS L. STANTON, U. S. D. J.:

My order dated February 17, 1998, finding no justification for the imposition of sanctions, was part of the joint appendix on appeal and was cited in Nu-Tech's June 15, 1998 brief (p. 34) to the Court of

Appeals. Accordingly, I do not assume that Court was unaware of my order, but rather take that Court's statement (190 F.3d 37 at 47) that I "made no findings regarding compliance with Rule 11(b)" as meaning that it regarded my findings as merely formalistic.

1.

I find as facts, and adopt and incorporate by reference as if fully repeated herein, Part I of the opinion of the Court of Appeals, 190 F.3d 37 at 40-42.

Defendant Nu-Tech argues for sanctions on the grounds succinctly stated in its June 15, 1998 Court of Appeals brief, pp. 34-35: that Gurary's claims "were without foundation in fact and without support in law" because his first two purchases were not in connection with the alleged fraud and his final two purchases were not made in reliance on any omission by Nu-Tech, which has unjustifiably been put to substantial effort and expense in its defense.

2.

On the facts, plaintiff could colorably argue (1) that he relied on the market price as indicating the fair market value of Nu-Tech common stock for his first two purchases, only to see it depressed by illegal market manipulation in violation of section 10(b) of the Securities Exchange Act of 1934, and (2) that in reliance

on Feigenbaum's promise to prevent further manipulation and stabilize the price, plaintiff made two further purchases on which (the promises proving worthless) he suffered even more losses. The continued manipulative short-selling ultimately reduced the stock's price from $15 per share to two dollars or less. Those losses (even if only on paper) resulted directly from his purchases and the co-conspirators' program of short sales, which Nu-Tech knew about and promised to, but did not prevent.

A conceivable extension of existing law might treat such a manipulative program as violating section 10(b)'s prohibition of "any manipulative or deceptive device or contrivance" and Rule 10b-5's prohibition of "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." Compare *Paul F. Newton & Co. v. Texas Commerce Bank,* 630 F.2d 1111 (5th Cir. 1980) (buyer, unreimbursed by its principal for stock purchased at artificially-inflated price, sues member of conspiracy which manipulated market, under § 10(b) and Rule 10b-5).

3.

Under *Oliveri v. Thompson,* 803 F.2d 1265 (2nd Cir. 1986) cert. denied 107 S. Ct. 1373 (1987), plaintiff

should not be sanctioned for seeking relief under the securities law which prohibits market manipulation. Although a more scholarly and meticulous practitioner, or one more expert in federal procedure and securities law, might have foreseen that the complaint would be dismissed, it cannot be said "that a competent attorney could not form the requisite responsible belief as to the validity" of plaintiff's claims. *Id.* at 1275. In such matters, "the court is to avoid hindsight and resolve all doubts in favor of the signer" of the pleading, and impose sanctions only when it is "patently clear that a claim has absolutely no chance of success." *Id.* quoting *Eastway Construction Corp. v. City of New York,* 762 F.2d 243, 254 (2nd Cir. 1985).

CONCLUSION

Nu-Tech's motion for sanctions is denied.

So ordered.

DATED: New York, New York
January 12, 2000

S/_____
LOUIS L. STANTON
U. S. D. J.

Appendix D

Decision of the United States Court of Appeals for the Second Circuit – Gurary II

No. 00-7151

MORDECHAI GURARY

Plaintiff- Appellant,

v.

ISAAC WINEHOUSE and ISAAC WINEHOUSE, doing business as Wall & Broad Equities, Defendants, NU-TECH BIO-MED, INC.

Defendant- Appellee.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

ARGUED SEPTEMBER 19, 2000

DECIDED DECEMBER 19, 2000

OPINION OF THE COURT

Before: WALKER, Chief Judge, and MINER and POOLER, Circuit Judges.

MINER, Circuit Judge:

Defendant-appellant Nu-Tech Bio-Med, Inc. ("Nu-Tech") appeals from an order entered in the United States District Court for the Southern District Court of New York (Stanton, J.) denying its motion for sanctions pursuant to the Private Securities Litigation Reform Act of 1995 ("PSLRA") and Federal Rule of Civil Procedure 11 ("Rule 11") against plaintiff-appellee Mordechai Gurary ("Gurary").

Gurary brought suit against Nu-Tech and defendant Isaac Winehouse ("Winehouse") to recover damages for securities fraud pursuant to section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78j, and 17 C.F.R. § 240.10b-5 ("Rule 10b-5") thereunder. The district court granted summary judgment in favor of both defendants and denied their motions for sanctions under Rule 11. We affirmed the summary judgment but remanded for further findings regarding compliance with Rule 11 as mandated by the PSLRA. See *Gurary v. Winehouse*, 190 F.3d 37, 47 (2d Cir. 1999). On remand, the district court concluded that sanctions were not warranted because "[a] conceivable extension of existing law might" render Gurary's claims of securities fraud properly pleaded. *Gurary v.*

Winehouse, 2000 U.S. Dist. LEXIS 188, *2, No. 97-3803, 2000 WL 20706, at *1 (S.D.N.Y. Jan. 12, 2000). For the reasons that follow, we affirm in part, and vacate in part the order of the district court and remand for further proceedings consistent with this opinion.

BACKGROUND

In November[**3] 1996, Nu-Tech raised nearly $14 million by issuing shares of Series A Convertible Preferred Stock (the "preferred"). That stock, while having no voting rights and paying no dividends, was convertible into common stock at the lesser of $17.50 per share or 75 percent of the average closing price of the common stock for the five trading days prior to the date of the holder's notice of conversion. Because the preferred paid no dividends, had no voting rights, and was convertible to common stock at a bargain price, it would almost always be converted. In addition, purchasers of the preferred were likely to profit from conversion no matter what happened to the price of the common stock, provided that the company survived. That is, so long as the price of the common did not fall more than 25 percent after conversion, shareholders of

the preferred would profit by conversion and sale of the common into which the preferred was converted.[1]

This litigation arose out of an alleged scheme by defendant Winehouse in which Winehouse allegedly organized a "cartel" to purchase a percentage of Nu-Tech convertible stock in the names of nominees. He allegedly arranged for a number of securities firms to become market makers in Nu-Tech common stock, and then proceeded to sell the common stock short,[2] allegedly to drive down the price of the common stock. Gurary concedes that this alleged manipulation did not begin before November 6, 1996.

On October 31, 1996, Gurary purchased 1,000 shares of Nu-Tech common stock at $14.60, and then on November 7, 1996, purchased another 5,500 shares at $15.50 per share. After becoming concerned about his

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[1] For example, if the common traded below $23.33 per share immediately prior to conversion, the preferred would be converted at 75 percent of the price (which would be less than $17.50). However, if the common traded above $23.33 immediately prior to conversion, the preferred would be converted at $17.50 (which would be less than 75 percent of the trading price of the common). In either scenario, investors would profit.

[2] A short sale involves the "sale of a security that the seller does not own or has not contracted for at the time of sale, and that the seller must borrow to make delivery." Black's Law Dictionary 1339 (7th ed. 1999).

investment when the stock price began to decline, Gurary spoke with J. Marvin Feigenbaum ("Feigenbaum"), chairman of Nu-Tech, sometime in December 1996. Feigenbaum assured Gurary that he had alerted Winehouse that Nu-Tech would refuse to register the common stock into which the preferred was convertible unless Winehouse and his group stopped shorting the common stock. Feigenbaum predicted that this "threat" would convince Winehouse to stop shorting the stock because a refusal to register the common issued upon conversion would force Winehouse to cover his short position by purchasing Nu-Tech common stock at a possibly higher price in the open market. Based on Feigenbaum's assurances, Gurary purchased another 1,000 shares on December 24, 1996, at a price of $11.75 per share. Gurary claims to have subsequently learned that Winehouse and his associates arranged to "borrow" an unlimited number of shares from market makers for the express purpose of continuing to short the stock using nominee names.

Gurary spoke to Feigenbaum again on February 18, 1997. Feigenbaum told Gurary that he had met that day with Winehouse and others in another attempt to stop the short selling. Feigenbaum explained to Gurary that Nu-Tech had offered to repurchase the group's preferred shares at cost plus ten percent and to allow

the group to keep its existing profits from the short sales if it would cease its activities. Although Winehouse refused the offer, Feigenbaum told Gurary that Nu-Tech would not surrender to Winehouse and would refuse to register the short sellers' shares. Apparently comforted by these assurances, Gurary bought another 8,350 shares of Nu-Tech common at a price of $11.57 that same day.

On March 12, 1997, Feigenbaum and another Nu-Tech board member met with Winehouse and asked that Winehouse and his group accept registration of the common stock into which their preferred was convertible over a period of twelve months rather than insisting that it be registered immediately. Winehouse refused this offer also and said that he would continue to sell short. Nu-Tech common stock dropped approximately $6 per share over the next two days as the Winehouse group continued its short sales. Six days later, Gurary, in a conference call arranged by an intermediary, spoke directly with Winehouse, who allegedly admitted to him that he deliberately had shorted the stock to drive the price down, that he intended to continue, and advised Gurary to sell his shares because the price would drop to "a dollar."

On May 23, 1997, Gurary brought suit against Nu-Tech and Winehouse in the United States District

Court for the Southern District of New York as a result of the alleged manipulation of the Nu-Tech stock. Gurary's complaint principally alleged that defendants Winehouse and Nu-Tech manipulated Nu-Tech's common stock in violation of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j, and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5, by making numerous misstatements and omissions of material fact in connection with the purchase and sale of the convertible preferred stock and the shorting of the common stock.[3] .

Both defendants moved to dismiss the complaint pursuant to Federal Rule of Civil Procedure 12(b)(6) for failure to state a claim upon which relief may be granted. In an Affidavit In Opposition to defendants' motion, Gurary's counsel, David Jaroslawicz, requested that he be granted leave to amend the complaint if the district court discovered any pleading deficiency. The district court, observing that Gurary's claims were

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[3] Gurary also brought a claim under section 349 of the New York General Business Law and sought a preliminary injunction to enjoin Nu-Tech from registering the convertible preferred stock pending the outcome of this action. These two pendent state law claims were dismissed for lack of subject matter jurisdiction after summary judgment was granted in favor of the defendants, and we affirmed. *See Gurary*, 190 F.3d at 47 n. 10.

based on four purchases, two purchases on October 31, 1996 and November 7, 1996, and two later purchases on December 24, 1996 and February 18, 1997, granted the motion in favor of Winehouse and Nu-Tech, after converting their 12(b)(6) motion into one for summary judgment.[4] However, the district court did not comment on Gurary's request for leave to amend and therefore implicitly denied it.

Gurary appealed to this Court, and defendants Nu-Tech and Winehouse cross-appealed on the grounds that the district court improperly denied their motions for sanctions made pursuant to the PSLRA. In an opinion dated August 24, 1999, we affirmed in part, and vacated and remanded in part. With respect to Gurary's first purchase on October 31, 1996, we concluded that this purchase failed to state a cognizable claim under Rule 10b-5 because Gurary failed to "allege culpable deception in connection with the purchase or sale of a security" in that the alleged manipulation did not commence until November 6, 1996, and Gurary's first purchase preceded that date. *Gurary*, 190 F.3d at 45

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[4] The district court converted these motions pursuant to Federal Rule of Civil Procedure 12(b)(2) because it considered Gurary's Affidavit In Opposition in rendering its decision. We approved the district court's conversion in the previous appeal. *See Gurary*, 190 F.3d at 43.

(internal quotation marks omitted). We also concluded that Gurary's second purchase failed to state a cognizable claim under Rule 10b-5 because Gurary, at the very most, paid less for the security on November 7, 1996, than he otherwise would have as a result of the defendants' alleged fraud. We noted that a defrauded buyer may only recover "the excess of what he paid over the value of what he got," not the opposite. *Id.* at 46 (internal quotation marks omitted). With respect to Gurary's last two purchases, we concluded that because "there [was] no suggestion in the complaint or in Gurary's affidavit that Feigenbaum did not intend to do just what he promised at the times he made the statements [to Gurary]," Gurary's claim under Rule 10b-5 was "fundamentally flawed" as it failed to allege that Feigenbaum secretly intended not to perform or knew that he could not perform. *Id.* at 44. We also vacated and remanded in part for the district court to make "findings regarding compliance with Rule 11(b) [as mandated by the PSLRA]." *Id.* at 47.

In an order dated January 12, 2000, the district court determined that sanctions were not warranted because Gurary "could colorably argue [based on a conceivable extension of the law:] (1) that he relied on the market price as indicating the fair market value of Nu-Tech common stock for his first two purchases, only

to see it depressed by illegal market manipulation in violation of...the...Exchange Act..., and (2) that in reliance on Feigenbaum's promise to prevent further manipulation and stabilize the price, [Gurary] made two further purchases on which (the promises proving worthless) he suffered even more losses." *Gurary*, 2000 WL 20706, at *1. In addition, the district court noted that "although a more scholarly and meticulous practitioner, or one more expert in federal procedure and securities law, might have foreseen that the complaint would be dismissed, it cannot be said that a competent attorney could not form the requisite responsible belief as to the validity of [Gurary's] claims." *Id.* (internal quotation marks omitted). Nu-Tech now appeals the district court's order.[5] We affirm in part, and vacate and remand in part for further proceedings consistent with this opinion.

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[5] Defendant Winehouse is not a party to the instant appeal.

DISCUSSION

I. THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 AND RULE 11

In 1995, Congress passed the PSLRA to give "teeth" to Rule 11, "recognizing the need to reduce significantly the filing of meritless securities lawsuits without hindering the ability of victims of fraud to pursue legitimate claims, and [because]...existing Rule 11 has not deterred abusive securities litigation." *Simon DeBartolo Group, L.P. v. Richard E. Jacobs Group. Inc.*, 186 F.3d 157, 166-67 (2d Cir. 1999) (internal quotation marks omitted). The PSLRA, which added section 21D(c), codified at 15 U.S.C. § 78u-4(c)(1), to the Exchange Act, requires that a district court make specific findings as to a party's compliance with Federal Rule of Civil Procedure 11(b) at the conclusion of a case arising under the Exchange Act, *see Simon DeBartolo Group, L.P.*, 186 F.3d at 167 (citing 15 U.S.C. § 78u-4(c)(1)), and also mandates the imposition of sanctions if the court determines that Rule 11 has been violated. *See* 15 U.S.C. § 78u-4(c)(2).

If a court finds a Rule 11 violation, "a rebuttable presumption [arises] that the appropriate sanction for a complaint that substantially fails to comply with Rule 11(b) 'is an award to the opposing party of the

reasonable attorneys' fees and other expenses incurred in the .. action.'" *Id.* (quoting 15 U.S.C. § 78u-4(c)(3)(A)(ii)). However, if a party against whom sanctions will be imposed successfully meets its burden by providing sufficient "rebuttal evidence" under 15 U.S.C. § 78u-4(c)(3)(B) that such fees and expenses are not appropriate, then courts should "award the sanctions [they] deem[] appropriate pursuant to Rule 11." 15 U.S.C. § 78u-4(c)(3)(C). The PSLRA does not alter the substantive standards for finding a Rule 11 violation but circumscribes "courts' discretion in choosing whether to conduct the Rule 11 inquiry at all and whether and how to sanction a party once a violation is found." *Simon DeBartolo Group, L.P.*, 186 F.3d at 167.

Rule 11(b) provides in relevant part that:

> By presenting to the court (whether by signing, filing, submitting, or later advocating) a pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances—
>
> ...

> (2) the claims, defenses, and other legal contentions therein are warranted by existing law or by a nonfrivolous argument for the extension, [**14] modification, or reversal of existing law or the establishment of new law;
>
> (3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery[.]

Fed. R. Civ. P. 11(b). The 1993 Advisory Committee Notes explain that Rule 11(b)(2) "establishes an objective standard, intended to eliminate any 'empty-head pure-heart' justification for patently frivolous arguments." Also, "the extent to which a litigant has researched the issues and found some support for its theories even in minority opinions, in law review articles, or through consultation with other attorneys should certainly be taken into account in determining whether paragraph [(b)](2) has been violated. Although arguments for a change of law are not required to be specifically so identified, a contention that is so identified should be viewed with greater tolerance under the rule." *Id.* While monetary sanctions may be imposed in some circumstances under Rule 11, see Fed. R. Civ. P. 11(c)(2), they "may not be awarded against a

represented party for a violation of subdivision (b)(2)," Fed. R. Civ. P. 11(c)(2)(A), because "responsibility for such violations is more properly placed solely on the party's attorneys." Fed. R. Civ. P. 11 (advisory committee notes to 1993 amendments); *see also Simon DeBartolo Group, L.P.*, 186 F.3d at 166.

II. STANDARD OF REVIEW

We review a district court's determination with respect to sanctions under the PSLRA and Rule 11 for abuse of discretion. *See Simon DeBartolo Group, L.P.*, 186 F.3d at 167 (citing *Cooter & Gell v. Hartmarx Corp.*, 496 U.S. 384, 405, 110 L. Ed. 2d 359, 110 S. Ct. 2447 (1990)). Rule 11 is violated when it is "clear under existing precedents that there is no chance of success and no reasonable argument to extend, modify or reverse the law as it stands." *Id.* (quoting *Mareno v. Rowe*, 910 F.2d 1043, 1047 (2d Cir. 1990)) (internal quotation marks omitted). That is, material errors of law constitute "per se abuses of discretion." *Id.*; *see also Cooter & Gell*, 496 U.S. at 405 (concluding that an erroneous view of the law would constitute abuse of a court's discretion); *Sussman v. Bank of Israel*, 56 F.3d 450, 456 (2d Cir. 1995) (same); *see also Pierce v. F.R. Tripler & Co.*, 955 F.2d 820, 831 (2d Cir. 1992) (finding an abuse of discretion where the district court awarded sanctions against a party

who has a good faith basis to pursue legal argument supported by one state court decision in the absence of contrary controlling authority).

III. IMPOSITION OF SANCTIONS

Citing *Eastway Construction Corp. v. City of New York,* appellant Nu-Tech asserts generally that the district court abused its discretion in denying sanctions against defendant-appellee Gurary because his claims against Nu-Tech involving all four purchases "failed to satisfy fundamental and threshold requirements for a Rule 10b-5 claim" and that Gurary has "failed...to suggest any reason that he could have achieved 'success under existing precedents,' and...has failed to advance any 'reasonable argument...to extend, modify or reverse the law as it stands.'" 762 F.2d 243, 254 (2d Cir. 1994). We agree with respect to Gurary's first two purchases, on October 31, 1996 and November 7, 1996, respectively, but disagree with respect to Gurary's December 24, 1996 and February 18, 1997 purchases.[6]

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[6] Gurary argues that the issue on appeal here is moot because we "overlooked" the fact the district court had already rendered such findings, and there was no need to remand. We disagree. First, we concluded that remand was required because the "district court made no findings regarding compliance with Rule 11(b)." *Gurary,* 190 F.3d at 47. Second, the only "findings"

(continued next page)

A. THE INITIAL PURCHASES: OCTOBER 31, 1996 AND NOVEMBER 7, 1996

The district court on remand concluded that sanctions were inappropriate because Gurary "could colorably argue...that he relied on the market price as indicating the fair market value of Nu-Tech common stock for his first two purchases, only to see it depressed by illegal market manipulation in violation of section 10(b) of the Securities Exchange Act of 1934." Gurary, 2000 WL 20706, at *1. That conclusion ignores both the plain language of the Exchange Act and well-settled case law prohibiting recovery on any claims arising out of Gurary's first two purchases, and we therefore conclude that the district court abused its discretion by not imposing sanctions in connection with these claims.

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder provide that a plaintiff must allege material

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made by the district court at the time it granted summary judgment included a conclusory statement that "the claims and arguments made in the complaint...were 'warranted by existing law or by a nonfrivolous argument for the extension, modification, or reversal of existing law or the establishment of new law'...and were not 'presented for any improper purpose.'" Accordingly, we have yet to review specific findings of the district court as mandated by the PSLRA.

misstatements or omissions indicating an intent to deceive or defraud "in connection with the purchase or sale of a security." 17 C.F.R. § 240.10b-5 (emphasis added); *see also Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737-38, 44 L. Ed. 2d 539, 95 S. Ct. 1917 (1975). Gurary's complaint alleges a violation of 10b-5 with respect to his first purchase on October 31, 1996, although Gurary concedes that the alleged manipulation of Nu-Tech's stock did not begin until at least November 6, 1996. Based on the plain language of section 10(b) and well-settled case law, Gurary's October 31, 1996 purchase could not under any circumstances give rise to a Rule 10b-5 cause of action because that purchase occurred before any alleged deception began, and therefore could not be in connection with the purchase or sale of a security. *See, e.g., Blue Chip Stamps*, 421 U.S. at 737-38; *see also* 15 U.S.C. § 10(b); 17 C.F.R. § 240.10b-5. Accordingly, Gurary's claim based on his October 31, 1996 security purchase was not warranted by existing law.

Nor could Gurary's claim be supported by any colorable argument for a change in existing law. The "in connection with the purchase or sale of a security" requirement of section 10(b) and Rule 10b-5 would prohibit a court from adopting a rule that would support Gurary's claim. This is not a case, in other

words, in which a litigant seeks only to swim upstream against the current of *stare decisis*, in which case a particularly trenchant argument for rejecting existing precedent might be availing. Rather, the statute and regulation applicable here are incapable of judicial revision and thus precluded the district court from adopting any theory that would impose liability for a purchase entirely unconnected with alleged fraud.

Similarly, Gurary's claim based on his second purchase was not sustainable under any existing theory of law. Under well-settled principles, a buyer defrauded in violation of the securities laws may "recover only the excess of what he paid over the value of what he got, not...the difference between the value of what he got and what it was represented he would be getting." *McMahan & Co. v. Wherehouse Entertainment, Inc.*, 65 F.3d 1044, 1049 (2d Cir. 1995) (quoting *Levine v. Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971)) (internal quotation marks omitted). That is, if the price of the common stock had been depressed because of the alleged manipulation, then a purchaser of a security actually benefits from that price decline by purchasing the stock at a lower price than he otherwise would have paid. Gurary alleged that the manipulation began on or about November 6, 1996, one day before his second purchase. As a result, if we infer that the

short selling scheme actually depressed the price of the common stock on November 7, 1996, then Gurary would have benefited from that manipulation by purchasing at a lower price than he otherwise would have paid. Consequently, because Gurary paid less for the security as a result of the defendants' alleged fraud or manipulation, there is no excess of price over value, and Gurary may not recover under Rule 10b-5. *See, e.g., Levine,* 439 F.2d at 334. Accordingly, Gurary's 10b-5 claim against Nu-Tech with respect to this second purchase was not warranted under existing law because it directly contradicts well-settled principles of Exchange Act jurisprudence.

Gurary made no argument before the district court for modification or extension of the law that would justify imposition of liability for his second purchase, and he also expressly refused to make any such argument on appeal. Although litigants are not required to articulate their arguments for legal change, see Fed. R. Civ. P. 11 (advisory committee notes to 1993 amendments) ("Arguments for a change of law are not required to be specifically so identified, [but] a contention that is so identified should be viewed with greater tolerance under the rule."), they fail to do so at the risk that a court may be unable to supply one sua sponte. Here we can conceive of no nonfrivolous

argument for a change in the law to save Gurary's claim based on the second purchase, and the district court was unable to make such an argument in its decision refusing to award sanctions. Accordingly, we must conclude that no nonfrivolous argument for the modification or extension of law can be made to save Gurary's claim, and that sanctions therefore were mandatory.

In accordance with the foregoing, Gurary's claim arising out of his first two purchases violated Rule 11(b)(2), and therefore sanctions are mandated pursuant to the PSLRA.[7] Nevertheless, Gurary asserts that *Simon DeBartolo Group, L.P.*, stands for the proposition "that where a complaint was dismissed but its merits were nevertheless arguable, sanctions under the PSLRA are not warranted." However, Gurary misconstrues our holding in *Simon DeBartolo Group, L.P.* In that case, we reversed the district court's determination that plaintiff DeBartolo's 10b-5 cause of

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[7] Gurary asserts that "if sanctions were for any reason to be imposed in this case, they should be diminished" because we have concluded generally that when some of a plaintiff's claims are deemed frivolous in violation of Rule 11 but others are not, the amount of sanctions should be reduced accordingly. *See, e.g., Simon Debartolo Group, L.P.*, 186 F.3d at 177-78. However, that issue is not

(continued next page)

action was frivolous "because there were non-frivolous allegations and arguments supporting each element of [DeBartolo's] Rule 10b-5 cause of action and [because] DeBartolo arguably had standing [based on existing case law] to assert [its] claim." 186 F.3d at 174.

As a consequence, we are constrained to conclude that the denial of sanctions pertaining to the claims arising out of Gurary's first two purchases constituted a material error of law. *See Simon DeBartolo Group, L.P.*, 186 F.3d at 167. We therefore remand for the district court to determine appropriate sanctions pursuant to 15 U.S.C. § 78u-4(c)(3)(A)-(C).[8]

B. THE SECOND TWO PURCHASES: DECEMBER 24, 1996 AND FEBRUARY 18, 1997

Nu-Tech urges that sanctions also must be imposed with respect to the claims based on the second two purchases because these claims too lack factual or

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before us and we do not address that issue in view of our decision to remand.

[8] We note here that because we find that these two claims violate Rule 11(b)(2), sanctions should only be imposed against Gurary's counsel and not Gurary himself. See Fed. R. Civ. P. 11(c)(2)(A) (prohibiting an award of monetary sanctions "against a represented party for a violation of subdivision 11(b)(2)").

legal support. In support of its argument, Nu-Tech points to our previous findings that "any allegation of reliance was 'fundamentally flawed'...because 'there is no suggestion in the complaint or Gurary's affidavit that Feigenbaum did not intend to do just what he promised.'" Gurary argues in opposition that his intent to plead scienter "could fairly have been gleaned from the gist of [his] complaint" and that he simply failed to satisfy a "pleading technicality," making sanctions unwarranted. Gurary's contention that he merely failed to comply with a "technicality" is something of an exaggeration. Gurary did not press his current theory in his complaint or affidavits filed before the district court. It was not until he appealed the dismissal that he began to argue that he relied on Feigenbaum's assurances in making the final two purchases. *See Gurary,* 190 F.3d at 44. In any event, the district court determined that sanctions were inappropriate with respect to these later two purchases because "in reliance on Feigenbaum's promise to prevent further manipulation and stabilize the price, [Gurary] made two further purchases on which (the promises proving worthless) he suffered even more losses." Gurary, 2000 WL 20706, at *1. While we disagree with the district court's reasoning and Gurary's position on appeal, we

agree that sanctions are not appropriate with respect to Gurary's second two purchases.

It is well-settled that "the failure to carry out a promise made in connection with a securities transaction is normally a breach of contract" and does not justify a Rule 10b-5 action. *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1176 (2d Cir. 1993). Such a promise does not constitute fraud pursuant to 10b-5 "unless, when the promise was made, the defendant secretly intended not to perform or knew that he could not perform." *Id.* We recognize that "there [was] no suggestion in the complaint or in Gurary's affidavit that Feigenbaum did not intend to do just what he promised at the times he made the [promissory] statements," *Gurary*, 190 F.3d at 44, and that Gurary therefore failed to adequately plead the requisite reliance on false statements made by Feigenbaum with scienter. *See, e.g., Ganino v. Citizens Util. Co.*, 228 F.3d 154, 161 (2d Cir. 2000) ("Plaintiff must plead that the defendant, in connection with the purchase or sale of securities, made a materially false statement or omitted a material fact, with scienter, and that plaintiff's reliance on the defendant's action caused [his] injury."); *see also* 17 C.F.R. § 240.10b-5. However, it does not necessarily follow that such a deficient pleading mandates a finding that Rule 11 has been violated.

David Jaroslawicz, Gurary's counsel, in an affidavit in opposition to Nu-Tech's motion to dismiss, requested leave to amend the complaint to comply with securities laws' pleading requirements in the event the district court decided to dismiss his claim for any reason. However, the district court never addressed Gurary's request to amend his complaint (nor did this Court on the previous appeal) and therefore implicitly denied it.

A district court has broad discretion in determining whether to grant leave to amend, and we review such determinations for abuse of discretion. *See, e.g., Commander Oil Corp. v. Barlo Equip. Corp.*, 215 F.3d 321, 333 (2d Cir. 2000) ("Leave to amend shall be freely given, and this court reviews the district court's actions for abuse of discretion."); *see also Monahan v. New York City Dep't of Corrections*, 214 F.3d 275, 283 (2d Cir. 2000) ("We review the district court's decision to grant a party leave to amend for abuse of discretion."). While the district court did not abuse its discretion by implicitly denying Gurary leave to amend his complaint to cure the deficiency, *see, e.g., Confederate Mem'l Assoc. v. Hines*, 301 U.S. App. D.C. 395, 995 F.2d 295, 299 (D.C. Cir. 1993) (holding that the district court did not abuse its discretion by denying leave to amend where plaintiffs made only a "bare request"), it would

also not have been an abuse of that court's discretion to allow the requested leave to amend. *See McLaughlin v. Anderson*, 962 F.2d 187, 195 (2d Cir. 1992) (stating that "lack of a formal motion is not [a] sufficient ground for a district court's dismissal without leave to amend, so long as the plaintiff has made its willingness to amend clear"); *see also Oliver Schs., Inc. v. Foley*, 930 F.2d 248, 252-53 (2d Cir. 1991) (noting that leave to amend should be granted even without an explicit motion where the adverse party had knowledge of desire to amend). Because we do not believe that the PSLRA was designed to mandate sanctions in all cases for a complaint that, if properly pleaded, could state a cognizable claim under the securities laws, we examine Gurary's case to determine whether an amendment could have stated such a claim.

Had Gurary been afforded the opportunity to amend his complaint to allege Feigenbaum's misrepresentations with proper specificity, as he apparently sought to do, Gurary could have asserted a cognizable claim under Rule 10b-5 with respect to his second two purchases. *See, e.g., Polar Molecular Corp.*, 12 F.3d at 1176. Gurary certainly had some basis for believing that evidence was available to demonstrate that Feigenbaum was making, with scienter, false representations regarding future events viz., that he

was able to, and would, head off the short sales being made by the Winehouse group. It simply cannot be said—at such an early stage in the proceedings that Gurary's claims based on the second two purchases would have completely lacked evidentiary support because Gurary was never afforded the opportunity to pursue discovery. Federal Rule of Civil Procedure 11(b)(3) specifically provides that the rule is not violated if the "allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery." Fed. R. Civ. P. 11(b)(3) (emphasis added). Accordingly, Gurary, after amending his complaint and through further investigation and discovery, could have developed some factual support that Feigenbaum "secretly intended not to perform or knew that he could not perform" the promises he made to Gurary. *See, e.g., Polar Molecular Corp.*, 12 F.3d at 1176.

Although Gurary's claim may not have survived summary judgment even with further discovery because of the inherent difficulty in establishing the subjective intent of Feigenbaum, we conclude that Gurary's failure to sufficiently plead the necessary elements of a cognizable 10b-5 claim does not warrant sanctions under the PSLRA in this instance because the

district court could have, within its broad discretion, afforded Gurary leave to amend his complaint, which would have resulted in a cognizable 10b-5 claim.

CONCLUSION

In accordance with the foregoing, the order of the district is affirmed on other grounds in part, and vacated and remanded in part for further determinations consistent with this opinion.

Appendix E

Order Denying Rehearing and Denying Rehearing En Banc of Gurary II

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, Foley Square, in the City of New York, on the ____ [sic] day of February two thousand one.

MORDECHAI GURARY,

Plaintiff-Appellee,

v.

ISSAC WINEHOUSE and ISSAC WINEHOUSE, doing business as Wall & Broad Equities,

Defendants,

NU-TECH BIO-MED, INC.,

Defendant-Appellant

Docket No. 00-7151

A petition for panel rehearing and a petition for rehearing en banc having been filed herein by the appellee Mordechai Gurary.

Upon consideration by the panel that decided the appeal, it is Ordered that said petition for rehearing is DENIED.

It is further noted that the petition for rehearing en banc has been transmitted to the judges for the court in regular active service and to any other judge that

heard the appeal and that no such judge has requested that a vote be taken thereon.

FOR THE COURT
ROSEANN B. MACKECHNIE, Clerk
By: S/_____
Beth J. Meador,
Administrative Attorney

[stamp:]

United States Court of Appeals
Filed
February 28, 2001
Roseann B. Mackechnie, Clerk
Second Circuit

Appendix F

Decision and Order of the United States District Court for the Southern District of New York on Remand After Gurary II, entered August 2, 2001

UNITED STATES DISTRICT COURT

FOR THE SOUTHERN DISTRICT OF NEW YORK

MORDECHAI GURARY,

Plaintiff,

-against-

ISAAC WINEHOUSE d/b/a WALL & BROAD EQUITIES and NU-TECH BIO-MED, INC,

Defendants.

97 Civ. 3803 (LLS)

August 1, 2001, Decided
August 2, 2001, Filed

LOUIS L. STANTON, U.S.D.J.:

This case is here on remand from the United States Court of Appeals for the Second Circuit, which affirmed the dismissal of Mr. Gurary's federal complaint alleging securities market manipulation in violation of section 10(b) of the Securities Exchange Act

of 1934 and the SEC's Rule 10b-5, *Gurary v. Winehouse*, 190 F.3d 37 (2d Cir. 1999) (*Gurary I*), and directed the imposition of sanctions with respect to claims predicated on his first two purchases, but not with respect to his remaining two purchases, *Gurary v. Winehouse*, 235 F.3d 792 (2d Cir. 2000) (*Gurary II*). Familiarity with those opinions is assumed.

Mr. Gurary claimed that the value of Nu-Tech shares he had purchased was depressed by a short-selling conspiracy initiated by the defendant Winehouse, and tolerated or concealed by the defendant Nu-Tech. However, his four purchases failed to support his federal securities-law claim: the first took place before the market manipulation began, the second (being at a lower price than the fair value of the stock, because of the artificial depression of the price) failed to present a cognizable damage claim, and he did not plead that Nu-Tech's chairman Feigenbaum was lying when, before Gurary made the final two purchases, Feigenbaum told him that he could and would compel Winehouse to stop the short sales. Thus, the summary dismissal of his claim was affirmed. *Gurary I*, 190 F.3d 37.

With respect to sanctions, *Gurary II* held that no colorable argument could be made for a change in existing law which would justify the claims based on

the first two transactions, and accordingly, sanctions must be imposed. However, since Gurary might possibly have made out a fraud claim with respect to the final two purchases, the Court of Appeals held that claims predicated on them were not sanctionable. *Gurary II*, 235 F.3d 792. It remanded for "the district court to determine appropriate sanctions pursuant to 15 U.S.C. § 78u-4(c)(3)(A)-(C)." *Id.* at 800.

The substantial failure of Gurary's complaint to comply with Fed.R.Civ.P. 11(b) invoked the presumption required by the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 78u-4(c)(3)(A), which provides that

> . . . the court shall adopt a presumption that the appropriate sanction–
>
> (i) . . .
>
> (ii) for substantial failure of any complaint to comply with any requirement of Rule 11(b) of the Federal Rules of Civil Procedure is an award to the opposing party of the reasonable attorneys' fees and other expenses incurred in the action.
>
> (B) Rebuttal Evidence. The presumption described in subparagraph (A) may be rebutted only upon proof by the party or attorney against whom sanctions are to be imposed that–

(i) the award of attorneys' fees and other expenses will impose an unreasonable burden on that party or attorney and would be unjust, and the failure to make such an award would not impose a greater burden on the party in whose favor sanctions are to be imposed; or

(ii) the violation of Rule 11(b) of the Federal Rules of Civil Procedure was de minimis.

(C) Sanctions.—If the party or attorney against whom sanctions are to be imposed meets its burden under subparagraph (B), the court shall award the sanctions that the court deems appropriate pursuant to Rule 11 of the Federal Rules of Civil Procedure.

Thus when the failure to comply with Rule 11 is substantial, the whole costs and attorneys' fees of the adversary are awarded as the sanction, unless plaintiff's attorney[1] proves that the burden on him will be unreasonable and unjust, or that the violation was de minimis.

This represents a change from the general law concerning sanctions, and the creation by Congress of a

---

[1] The Court of Appeals found (235 F.3d at 800, fn. 8) that sanctions should only be imposed against Gurary's counsel, not against Gurary himself.

special rule "strengthening the application of Rule 11 of the Federal Rules of Civil Procedure in private securities actions" (H.R. Conf. Rep. No. 104-369, p. 39 (Nov. 28, 1994)) in light of Congress' perception that courts often failed to impose sanctions when they were warranted, and that even when sanctions were awarded—

> . . . they are generally insufficient to make whole the victim of a Rule 11 violation: the amount of the sanction is limited to an amount that the court deems sufficient to deter repetition of the sanctioned conduct, rather than imposing a sanction that equals the costs imposed on the victim by the violation. Finally, courts have been unable to apply Rule 11 to the complaint in such a way that the victim of the ensuing lawsuit is compensated for all attorneys' fees and costs incurred in the entire action.

Id.

As stated in *Simon DeBartolo Group v. Richard E. Jacobs Group*, 186 F.3d 157, 166-167 (2d Cir. 1999), a federal securities action is no longer an ordinary case for sanctions:

Ordinarily, courts are under no particular obligation to make findings with regard to the compliance of litigants and their counsel with Rule 11

or to impose sanctions once a violation is found. See Fed.R.Civ.P. 11(c)(1). This is no longer the case, however, in the securities litigation context. Recognizing what it termed "the need to reduce significantly the filing of meritless securities lawsuits without hindering the ability of victims of fraud to pursue legitimate claims, "and commenting that the "existing Rule 11 has not deterred abusive securities litigation," the 104th Congress included in the Private Securities Litigation Reform Act of 1995 ("PSLRA") a measure intended to put "teeth" in Rule 11. H.R.Conf. Rep. No. 104-369 (1995), reprinted in 1995 U.S.C.C.A.N. 730. In relevant part, the PSLRA added Section 21D(c) to the Securities Exchange Act of 1934 ("Exchange Act"), requiring courts, at the conclusion of all private actions arising under the Exchange Act, to make specific findings as to the compliance by all parties and attorneys with Fed.R.Civ.P. 11(b). See 15 U.S.C. § 78u-4(c)(1). Section 21D(c) requires also that the court impose sanctions if it determines the rule has been violated, and adopts a rebuttable presumption that the appropriate sanction for a complaint that substantially fails to comply with Rule 11(b) "is an award to the opposing party of the reasonable attorneys' fees and other expenses incurred in the action." 15 U.S.C. § 78u-4(c)(3)(A)(ii). The PSLRA thus does not in any way

purport to alter the substantive standards for finding a violation of Rule 11, but functions merely to reduce courts' discretion in choosing whether to conduct the Rule 11 inquiry at all and whether and how to sanction a party once a violation is found.

In *DeBartolo,* the Court of Appeals held that the district court was required to impose sanctions with respect to DeBartolo's claim under SEC Rule 10b-13, but not for the claim under Rule 10b-5. *Id.* at 168-176. Expressing doubt whether "when a single claim in an action is frivolous, the proper sanction is reasonable attorneys' fees and other expenses incurred in the entire action" (*id.* at 178) (emphasis in original), it remanded for the district court to determine whether the complaint represented "a substantial failure" to comply with Rule 11. If it did not, the statute's rebuttable presumption in favor of attorney's fees would be inapplicable. *Id.*

In *Inter-County Resources, Inc. v. Medical Resources, Inc.,* 49 F. Supp. 2d 682 (S.D.N.Y. 1999), the court determined that a frivolous 10b-5 claim required sanctions and invoked the presumptive award of the opposing party's attorneys' fees (*Id.* at 685), but found that plaintiff's counsel had rebutted the presumption by showing that such an award would be unjust and impose an unreasonable burden on her, since her four

other claims were not so patently defective and might have required defense in federal court. Accordingly, the court imposed sanctions of approximately one fifth of the total expenses incurred (*id.* at 686).

In a more complex situation, *Polar Int'l Brokerage Corp. v. Reeve,* 196 F.R.D. 13 (S.D.N.Y. 2000), on reconsideration, 120 F. Supp. 2d 267 (S.D.N.Y. 2000), aff'd, 258 F.3d 86, 2001 U.S. App. LEXIS 15591, 2001 WL 811203 (2d Cir. 2001), involving five claims and two firms of counsel for plaintiff, the court discounted the award of attorneys' fees and expenses by 20% because one of the five claims was colorable. 196 F.R.D. at 19.

None of those cases requires, and no party has brought to our attention any case construing the statute as requiring, a plaintiff who has stated a potentially non-frivolous claim to reimburse the whole of his adversary's costs and attorneys' fees. Indeed, to impose the whole costs of the case on such a plaintiff would in the statutory language "impose an unreasonable burden on that party or attorney and would be unjust, and the failure to make such an award would not impose a greater burden on the party in whose favor sanctions are to be imposed. . . ."

In *DeBartolo,* the district court had held that both of plaintiff's two claims, one under the SEC's Rule 10b-5 and the other under its Rule 10b-13, were frivolous and

imposed sanctions totaling $100,000. 985 F. Supp. 427 (S.D.N.Y. 1997). The Court of Appeals affirmed as to the 10b-13 claim, but reversed as to the 10b-5 claim, holding it non-frivolous, 186 F.3d at 174-78. Since one of the two claims was non-sanctionable, the Court of Appeals recommended reduction of the amount of monetary sanctions (*id.* at 178):

> If the district court decides that monetary sanctions are still warranted, we note our understanding that the proper level of an award for the firm's assertion of a frivolous claim is likely to be substantially less than was the level of sanctions the court actually awarded on the basis of what we now hold to be its mistaken conclusion that the action was frivolous in its entirety.

In the instant case, reducing Nu-Tech's total costs and fees by half is particularly appropriate since the Court of Appeals concluded, as to two of plaintiff's four purchases:

> that Gurary's failure to sufficiently plead the necessary elements of a cognizable 10b-5 claim does not warrant sanctions under the PSLRA in this instance because the district court could have, within its broad discretion, afforded Gurary leave to amend his complaint, which would have resulted in a cognizable 10b-5 claim.

235 F.3d 792 at 801.

With respect to the amount of sanctions, even removing all unrelated or duplicative time charges and resolving against Nu-Tech all reservations expressed by plaintiff, Nu-Tech expended $125,112.57 in defending this case and obtaining sanctions, including two full appeals in the Court of Appeals. Half of that sum is $62,556.28, which is a reasonable and just amount of sanctions to impose under the circumstances and in conformity with law.

Plaintiff's counsel's arguments to the contrary are unacceptable. His assertion that the violation was de minimis because defense of the "non-frivolous" claim would be necessary anyway would turn the statute and the Court of Appeals decision on their heads. As the Court of Appeals made clear, the violation was substantial. His argument that his adversary should have maintained separate time records for the work on each of the four purchases is absurd: Nu-Tech's counsel was defending a single securities-law claim, and had no need to allocate separately the work on each element on which the claim foundered. His suggestion that a ratio be struck between the frivolous and non-frivolous elements by counting the number of pages in the briefs devoted to each disregards the statutory presumption that all costs

and fees are awarded, unless the violation is found to be de minimis or such an award is shown to be unreasonable and unjust. Finally, although he says his is a small law firm and he is ill, he offers no facts concerning his financial position, income, expenses, assets or liabilities, profits or losses, medical expenses, or the like.

CONCLUSION

David Jaroslawicz, Esq. and Jaroslawicz & Jaros, 150 William Street, New York, New York, jointly and severally, shall promptly pay the sum of $62,556.28 to defendant Nu-Tech Bio-Med, Inc., now known as United Diagnostic, Inc. If submitted, a judgment to that effect may be entered, with execution to issue thereon according to law.

So ordered.

DATED: New York, New York
August 1, 2001

LOUIS L. STANTON
U. S. D. J.

Appendix G

Decision of the United States Court of Appeals for the Second Circuit – Gurary III

Nos. 01-7969; 01-9000

MORDECHAI GURARY

Plaintiff- Appellant,

v.

ISAAC WINEHOUSE and ISAAC WINEHOUSE, doing business as Wall & Broad Equities, Defendants, NU-TECH BIO-MED, INC.

Defendant- Appellee.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

ARGUED MAY 16, 2002

DECIDED AUGUST 23, 2002

OPINION OF THE COURT

Before: WALKER, Chief Judge, and WINTER and CALABRESI, Circuit Judges.

CALABRESI, Circuit Judge:

Responding to what it perceived to be an unwillingness on the part of courts to impose discretionary sanctions on parties who brought abusive securities fraud lawsuits, Congress passed Section 21D(c) of the Private Securities Litigation Reform Act of 1995 (PSLRA), 15 U.S.C. § 78u-4(c). *See* S. Rep. No. 104-98, at 13 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 692. While the mischief that Congress was addressing is clear, the statutory language Congress employed is not.

The PSLRA dictates sanctions for frivolous securities fraud complaints and emphasizes the need not only to deter such abusive lawsuits, but also to compensate fully victims of this kind of abusive litigation. It requires district courts overseeing securities fraud suits to make specific findings, upon final adjudication of the action, as to whether all parties and all attorneys have complied with each requirement of Rule 11(b) of the Federal Rules of Civil Procedure. § 78u-4(c)(1). If the court determines that a violation has occurred, the imposition of sanctions is mandatory. § 78u-4(c)(2). The PSLRA further establishes a presumption that, "for substantial failure of any complaint to comply with any requirement" of Rule

11(b), the award shall be the full amount of the reasonable attorneys' fees and costs. n1 § 78u-4(c)(3)(A) (emphasis added). Under the statute, this presumption may be rebutted only upon proof that "the violation of [Rule 11(b)] was de minimis" or that the sanctions "will impose an unreasonable burden on that party or attorney and would be unjust, and the failure to make such an award would not impose a greater burden on the party in whose favor sanctions are to be imposed." § 78u-4(c)(3)(B).[1]

On their own terms these provisions present problems. Thus, one might well read the requirement

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[1] Rule 11(b) states, in relevant part, that:

By presenting to the court (whether by signing, filing, submitting, or later advocating) a pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances, -

(1) it is not being presented for any improper purpose . . .

(2) the claims, defenses, and other legal contentions therein are warranted by existing law or by a nonfrivolous argument for the extension, modification, or reversal of existing law or the establishment of new law;

(3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery . . . .

Fed. R. Civ. P. 11(b).

that the violation be a "substantial failure," for purposes of applying the presumption of an award of full fees and costs, to mean that the violation must not be de minimis. But such a reading would make hash of the statute's subsequent provision that a party may rebut this presumption by showing that the violation was de minimis. We must, therefore, read the requirement of a "substantial failure" to mean something else. But what? The matter is made more complex by the fact that the words "substantial failure" and "de minimis" give no guidance as to the proper extent of mandated sanctions when frivolous counts or allegations are part of a suit in which some of the other counts or allegations are not only not frivolous, but may actually have merit. The present case requires us to address these matters.

Attorney David Jaroslawicz and his law firm, Jaroslawicz & Jaros, appeal a judgment from the United States District Court for the Southern District of New York (Stanton, J.), imposing sanctions on Jaroslawicz and his law firm pursuant to Rule 11(b) and § 21D(c) of the PSLRA in the amount of $62,556.28, or approximately one-half of defendant Nu-Tech's costs and attorneys' fees. The sanctions arose out of an action brought by Gurary, a purchaser of common stock in Nu-Tech, in which Gurary alleged securities fraud

violations by Nu-Tech and Isaac Winehouse. Gurary claimed that Winehouse was the leader of a "cartel" that purchased convertible preferred stock and manipulated stock prices by short selling in violation of Section 10b of the Securities Exchange Act of 1934, 15 U.S.C. § 78j, and 17 C.F.R. § 240.10b-5 ("Rule 10b-5"), as well as § 349 of the General Business Law of the State of New York. According to Gurary's various theories of recovery, Nu-Tech knew of the short selling and committed fraud by concealing material information and providing misinformation in violation of Rule 10b-5.

The district court dismissed the complaint and we affirmed that dismissal. *Gurary v. Winehouse ("Gurary I"), 190 F.3d 37 (2d Cir. 1999).* We subsequently directed the imposition of sanctions with respect to two of Gurary's four claims against Nu-Tech, *Gurary v. Winehouse ("Gurary II")*, 235 F.3d 792 (2d Cir. 2000). On remand, the district court ordered sanctions against attorney Jaroslawicz and his firm in an amount equal to approximately one-half of Nu-Tech's attorneys' fees and costs in the action. Before us, Jaroslawicz challenges several aspects of the district court's sanctions ruling. At the same time, Nu-Tech claims, in a cross-appeal, that the court committed legal error by

not imposing sanctions equal to all of Nu-Tech's costs and fees.

BACKGROUND

In his securities lawsuit, Gurary alleged that in November of 1996 Nu-Tech privately issued 14,000 shares of "Series A Convertible Preferred Stock" for a total price of $14 million. Gurary claimed that Winehouse and his cartel arranged to buy a large part of the Convertible Stock in the name of third parties. The Winehouse cartel then allegedly began selling Nu-Tech common stock short, using various accounts to conceal the identity of its members. It could sell short in relative safety because of its ownership of the Convertible Preferred Stocks. According to Gurary, the cartel's purpose was to manipulate the market and drive down the price of Nu-Tech shares.

In his complaint, Gurary states that on four occasions he purchased shares of Nu-Tech common: (1) 1,000 shares on October 31, 1996, for $14.60 per share; (2) 5,500 shares on November 7, 1996, for $15.50; (3) 1,000 shares on December 24, 1996, for $11.75; and (4) 8,350 shares on February 18, 1997, for $11.57. In December 1996, after Gurary's first two purchases, the stock price began to decline, presumably as a result of

the short selling. Gurary further alleges that Marvin Feigenbaum, chairman of Nu-Tech, assured Gurary that Feigenbaum had informed Winehouse that Nu-Tech would refuse to register any stock that would be converted from Convertible Preferred Stock to common stock unless Winehouse stopped shorting the common. Gurary states that he made his third purchase of common stock on December 24, 1996 based upon Feigenbaum's assurances.

Gurary continues that upon learning that Winehouse and his associates had persisted in shorting the stock, Gurary again spoke with Feigenbaum on February 18, 1997. Feigenbaum explained that he had met with Winehouse's group and offered to repurchase their stock at cost plus ten percent if the group would cease its activities. Winehouse rejected the offer, but Feigenbaum reemphasized that Nu-Tech would refuse to register the short sellers' shares. Apparently comforted by this information, Gurary made his fourth purchase later that same day.

On March 12, 1997, Feigenbaum made an unsuccessful attempt to negotiate an agreement with Winehouse that would end the short selling. The Nu-Tech stock dropped approximately $6 a share over the next two days. Nu-Tech issued a press release on March 14, 1997, which stated that the price decline could be

attributed to "possible sales by shareholders," but Nu-Tech did not mention the discussions with Winehouse. During a conversation a few days later, Winehouse admitted to Gurary that he deliberately had shorted the stock to drive prices down and that he intended to continue doing so.

On May 23, 1997, Gurary began this action against Winehouse and Nu-Tech. Gurary charged Winehouse with manipulation of the common stock in violation of Rule 10b-5, by purchasing the Convertible Preferred and shorting the common. He alleged that Nu-Tech had engaged in fraud by concealing material information and providing misinformation in violation of Rule 10b-5.[2] And he asserted that both of the defendants' conduct constituted fraudulent business practice in violation of § 349 of the General Business Law of the State of New York.

The district court granted the defendants' motion for summary judgment on the federal claims, but implicitly denied their motion for sanctions pursuant to Rule 11(b) and the PSLRA. *Gurary v. Winehouse*, 1998 U.S. Dist. LEXIS 1429, No. 97 Civ. 3803, 1998 WL 54641, at *2-3 (S.D.N.Y. Feb. 10, 1998). It also

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[2] It is only this federal claim, by Gurary against Nu-Tech, that is relevant to the appeal now before us.

declined to exercise jurisdiction over the state law claim in light of the disposition of the federal allegations. *Id.* at *3. Gurary appealed and Nu-Tech cross-appealed. We affirmed the dismissal of the federal as well as the state claims, and vacated and remanded with respect to the denial of sanctions because "the district court [had] made no findings regarding compliance with Rule 11(b)" as mandated by the PSLRA. *Gurary I, 190 F.3d at 39, 47.*

On remand, the district court determined that sanctions were not warranted because Gurary could colorably argue that an extension of existing case law supported his Rule 10b-5 causes of action. *Gurary v. Winehouse,* 2000 U.S. Dist. LEXIS 188, No. 97 Civ. 3803, 2000 WL 20706, at *1 (S.D.N.Y. Jan. 12, 2000). Only Nu-Tech appealed this denial.

In Gurary II, the district court's ruling was affirmed in part, and vacated and remanded in part. *Gurary II,* 235 F.3d at 797. We held that sanctions were warranted because the claims against Nu-Tech, based upon Gurary's first two purchases (October 31 and November 6, 1996), were frivolous. We also held, however, that sanctions could not be grounded on the nonfrivolous, but meritless, claims (also against Nu-Tech) involving the last two purchases (December 24, 1996 and February 18, 1997). Our opinion concluded

that "based upon the plain language of section 10(b) and well-settled case law, Gurary's October 31, 1996 purchase could not under any circumstances give rise to a Rule 10b-5 cause of action because that purchase occurred before any alleged deception began, and therefore could not be in connection with the purchase or sale of a security" as required by the statute. *Id. at 799.* The November 7, 1996 purchase similarly failed to state a colorable claim because the short selling scheme, which began November 6, 1996, had actually depressed the price of the common stock, to Gurary's benefit. *Id.* These frivolous claims were, therefore, sanctionable pursuant to the PSLRA and Rule 11(b).

With respect to the claims based upon the last two purchases, we held that if the district court had afforded Gurary the opportunity to amend his complaint, as he requested, "Gurary could have asserted a cognizable claim under Rule 10b-5." *Id. at 801-02.* We noted that in his original complaint and affidavits Gurary had "failed to adequately plead the requisite reliance on false statements made by Feigenbaum with scienter." *Id. at 801;* see also 17 C.F.R. § 240.10b-5; *Ganino v. Citizens Util. Co.*, 228 F.3d 154, 161 (2d Cir. 2000) ("Plaintiff must plead that the defendant, in connection with the purchase or sale of securities, made a materially false statement or omitted a material

fact, with scienter, and that plaintiff's reliance on the defendant's action caused [his] injury.").

This failure to comply with the PSLRA's heightened pleading requirements did not, however, necessarily result in a Rule 11 violation. In opposition to the motion to dismiss, Jaroslawicz, as mentioned above, had requested the opportunity to amend the complaint. The district court implicitly denied this request by granting summary judgment for the defendants. Gurary did not challenge the denial. But on appeal from the dismissal of his complaint Gurary, for the first time, asserted the theory that Feigenbaum's fraudulent statements had been made with malice and that Gurary had relied on them in making his last two purchases. Accordingly, we concluded that "although Gurary's claim may not have survived summary judgment even with further discovery because of the inherent difficulty in establishing the subjective intent of Feigenbaum, . . . Gurary's failure to sufficiently plead the necessary elements of a cognizable 10b-5 claim does not warrant sanctions under the PSLRA," since losing, though not frivolous, claims could have been made by amending the complaint with respect to these two purchases. *Id.* at 802. We then remanded the case to the district court to impose appropriate sanctions pursuant

to the PSLRA for the claims based upon the first two purchases.

The district court, on this remand, stated that the "substantial failure of Gurary's complaint to comply with Fed. R. Civ. P. 11(b) invoked the presumption required by" the PSLRA. *Gurary v. Winehouse*, 153 F. Supp. 2d 489, 491 (S.D.N.Y. 2001). The court further noted that "when the failure to comply with Rule 11 is substantial, the whole costs and attorneys' fees of the adversary are awarded as the sanction, unless plaintiff's attorney proves that the burden on him will be unreasonable and unjust, or that the violation was de minimis." *Id.* (footnote omitted).

Relying upon our decision in *Simon DeBartolo Group v. Richard E. Jacobs Group, Inc.*, 186 F.3d 157 (2d Cir. 1999), the lower court then found that the presumptive sanctions would impose an unreasonable burden. *Gurary*, 153 F. Supp. 2d at 493. The court reasoned that, because two out of the four claims were potentially nonfrivolous, "to impose the whole costs of the case on [a] plaintiff would in the statutory language 'impose an unreasonable burden on that party or attorney and would be unjust, and the failure to make such an award would not impose a greater burden on the party in whose favor sanctions are to be imposed.'" *Id.* at 492-93 (quoting § 78u-4(c)(3)(B)(i)). Although it

found the presumption rebutted because it would create an unreasonable burden, the court rejected Gurary's contention that the violation was de minimis. Equating the "substantial failure" analysis with the de minimis inquiry, the court noted that "as the Court of Appeals made clear, the violation was substantial," and, hence, it could not be de minimis. *Id.* at 493. The court assessed sanctions upon Jaroslawicz, Gurary's attorney, and his firm in the amount equal to approximately one-half of the fees and costs—including the expenses associated with the sanctions application itself—incurred in the entire action. *Id.*

On appeal, Jaroslawicz argues that the district court abused its discretion because, if sanctions are imposed, they should be limited to the fees and costs actually borne as a result of the frivolous claims rather than be charged at one-half of the total expenses. He also contends that the district court erred by including in the award the legal fees and costs for work performed for the sanctions application itself. Nu-Tech cross-appeals, claiming that, given the district court's finding of a substantial violation of Rule 11, Jaroslawicz's evidence was insufficient to rebut the PSLRA's presumption that full fees and costs were the proper sanction amount. According to Nu-Tech, the

district court, therefore, exceeded its authority under the statute in reducing the award.

DISCUSSION

We review the district court's conclusions of law de novo, *Connecticut v. Physicians Health Servs. of Conn., Inc.*, 287 F.3d 110, 114 (2d Cir. 2002), and its imposition of sanctions under the PSLRA and Rule 11 for abuse of discretion, *Simon DeBartolo*, 186 F.3d at 167.

The language of the PSLRA does not make clear whether a complaint containing both frivolous and nonfrivolous allegations triggers the statutory presumption, and, if so, whether the presence of nonfrivolous allegations, by itself, rebuts that presumption by constituting evidence either that the violation is de minimis or that the assessment of full sanctions is an unreasonable and unjust burden. After examining the meaning of "substantial failure," "de minimis," and "unreasonable burden" in the context of complaints involving both frivolous and nonfrivolous charges, we hold that, in the circumstances of this case, the violation was substantial, and that the plaintiff failed to rebut the presumption that full compensation is the proper sanction.

I. THE MEANING OF THE PSLRA SANCTION PROVISIONS

A. THE UNDERLYING PURPOSE OF THE PSLRA

As we stated in Simon DeBartolo, "recognizing what it termed 'the need to reduce significantly the filing of meritless securities lawsuits without hindering the ability of victims of fraud to pursue legitimate claims,' and commenting that the 'existing Rule 11 has not deterred abusive securities litigation,' the 104th Congress included in the [PSLRA] a measure intended to put 'teeth' in Rule 11." *Id. at 166-67* (quoting H.R. Conf. Rep. No. 104-369 (1995), at 39, reprinted in 1995 U.S.C.C.A.N. 730, 738). The PSLRA's sanction regime was one of several provisions designed to reduce the economic incentives for bringing these actions.

Congress was concerned about the failure of courts to impose sanctions pursuant to Rule 11, even in cases in which penalties were warranted. Accordingly, the PSLRA required (a) mandatory findings regarding compliance with Rule 11(b), § 78u-4(c)(1) ("In any private action arising under this chapter, upon final adjudication of the action, the court shall include in the record specific findings regarding compliance by . . . each attorney representing any party with each

requirement of [Rule 11(b)] as to any complaint . . . ."), and (b) mandatory sanctions whenever any portion of the complaint violated Rule 11, § 78u-4(c)(2) ("If the court makes a finding under paragraph (1) that an . . . attorney violated any requirement of [Rule 11(b)] as to any complaint . . ., the court shall impose sanctions on such . . . attorney in accordance with [Rule 11(b)].").

Congress was also troubled by the fact that under existing Rule 11 practice, when a court did award Rule 11 sanctions, the award was "generally insufficient to make whole the victim of a Rule 11 violation; the amount of the sanction [was] limited to an amount that the court deemed sufficient to deter repetition of the sanctioned conduct, rather than imposing a sanction that equals the costs imposed on the victim of the violation." H. Conf. Rep. No. 104-349, at 39, reprinted in 1995 U.S.C.C.A.N. 738. This concern led to the establishment of the presumption in the PSLRA that full fees and costs were the proper sanction for a violation of Rule 11.

The mandatory and broad nature of the presumption, however, was tempered by limiting it only to those cases in which the failure to comply with Rule 11 was "substantial." During the drafting of the legislation, the addition of the qualifier "substantial" was suggested by Judge Anthony Scirica of the United

States Court of Appeals for the Third Circuit as a means of indicating that the presumption was reserved for only a "serious offense—filing an unfounded action." See 141 Cong. Rec. S19044, S19055 (Dec. 21, 1995) (Letter to the Senate Committee on Banking, Housing and Urban Affairs from Judge Anthony J. Scirica). But Judge Scirica further noted that, without an additional modification to indicate the consequences of a small offense, "a gap is left in the statutory scheme." *Id.* And while Congress adopted Judge Scirica's "substantial failure" language, the legislators failed to address his second concern and did not define clearly what was meant by a "substantial failure."

This failure left uncertain the applicability of the PSLRA's presumption in cases in which the security fraud complaint presents both frivolous and nonfrivolous claims, a problem that Congress did not seem to have in mind. Thus, the legislative history of the PSLRA focused for the most part on abusive securities litigation without considering the possibility that these suits might also contain nonfrivolous claims. The only acknowledgment of this issue is the congressional statement that when one claim in a twenty-count complaint is frivolous, the violation is de minimis and, hence, the presumption is rebutted. See

H. R. Conf. Rep. No. 104-349, at 39-40, reprinted in 1995 U.S.C.C.A.N. 738-39.

A securities complaint may, however, present frivolous claims joined with nonfrivolous claims in a wide variety of ways, including the combination of frivolous claims with (1) valid, winning claims; (2) claims lost before a jury but which are meritorious enough to survive summary dismissal; (3) claims that, though properly dismissed at summary judgment because capable of resolution as a matter of law, presented novel legal issues that could well have gone in the plaintiff's favor; and (4) summarily dismissed claims that, while not legally frivolous, lack any merit. The statutory language leaves unclear which of these situations create a substantial violation of Rule 11. It is possible that in certain of these scenarios a complaint is not, in Judge Scirica's language, "unfounded," and, hence, should not be deemed a substantial violation. In others, instead, the violation may well remain substantial despite the presence of nonfrivolous claims. Further, the PSLRA's language does not indicate whether the mere presence of a nonfrivolous claim can suffice either to make even a substantial violation de minimis or to make the imposition of full sanctions unreasonable and unjust, thereby rebutting the statutory violation.

B. DE MINIMIS VIOLATIONS

Appellant Jaroslawicz argues that a complaint containing any nonfrivolous allegation (a) is not a substantial violation that gives rise to the PSLRA's presumption, and, (b) even if it were, falls both within the de minimis and the unreasonable burden defenses. But to accept these contentions would permit the very mischief that Congress manifestly intended to prohibit. Plaintiffs could avoid mandatory sanctions, and return to the prior discretionary regime, simply by including one colorable claim amid a myriad of abusive allegations.

Accepting Jaroslawicz's definition of de minimis, moreover, also runs counter to unusually clear legislative history. Once a substantial violation has been found and the presumption established, the Conference Committee wrote:

> [the presumption] does not mean that a party who is sanctioned for only a partial failure of the complaint under Rule 11, such as one count out of a 20-count complaint, must pay for all of the attorney's fees and costs associated with the action. The Conference Committee expects that courts will grant relief from the presumption where a de minimis violation of the Rule has occurred.

H. R. Conf. Rep. No. 104-369 at 39-40, reprinted in 1995 U.S.C.C.A.N. at 738-39.

C. UNREASONABLE BURDEN

Jaroslawicz contends that even if the de minimis clause cannot be read as limiting sanctions in complaints that contain any nonfrivolous allegations, the unreasonable burden prong of the PSLRA's rebuttal provision should be understood to mean that the entire fees and costs ought not to be granted when only part of the complaint was frivolous. But, as indicated above, this, as much or more than an expansive reading of de minimis, would negate the congressional intent underlying the PSLRA's sanction scheme. For the presence of any nonfrivolous claim would again mean that, rather than being bound by the mandates of the PSLRA, courts would be free to engage in the ordinary Rule 11 analysis, which Congress found too often resulted in the failure to compensate fully victims of abusive securities litigation.

Moreover, both the ordinary meaning of "unreasonable burden" and its context in the PSLRA indicate that the statute's unreasonable burden prong requires the sanctioned party to offer, through financial statements or other proof, evidence that the award is unreasonable and unjust, given the party's economic or

other like status. Thus, the district court is required to compare the burden on the sanctioned party to the burden placed on the victim of the litigation, given the victim's financial or similar status. See § 78u-4(c)(3)(B) ("The presumption . . . may be rebutted only upon proof . . . that (I) the award of attorneys' fees and other expenses will impose an unreasonable burden on that . . . attorney and would be unjust, and the failure to make such an award would not impose a greater burden on the [victim of the abusive litigation] . . . ."); see also S. Rep. No. 104-98, at 14, reprinted in 1995 U.S.C.C.A.N. 693 (noting that under this prong, courts should "take into account the relevant circumstances of each case" as proven by the parties).

We conclude that, once a substantial violation is found, the existence of some nonfrivolous claims does not suffice to rebut the statutory presumption on the ground that full sanctions would be an unreasonable and unjust burden.

D. SUBSTANTIAL VIOLATION

All this returns us to the statutory requirement that, in making the mandatory findings under the PSLRA, the district court should initially determine whether or not a violation of Rule 11 occurred, and if it has, whether the failure to comply with Rule 11 was

substantial. And, as we have emphasized, only if the failure is substantial does the presumption of full sanctions arise. What then is a substantial violation?

Nu-Tech argues that a substantial violation occurs whenever the nonfrivolous claims that are joined with frivolous ones are insufficiently meritorious to save the complaint as a whole from being abusive. Under this interpretation, the district court must examine the qualitative substance of the nonfrivolous claims in order to assess whether these claims were, in fact, legitimate filings that had the potential of prevailing or whether they patently lacked merit and only narrowly avoided being deemed frivolous themselves.

There is much to be said for this reading of the statute, and we adopt it today. First, it gives a meaning to "substantial failure" that is not simply the opposite of de minimis. It thereby avoids what would be a paradoxical result—that the presumption is rebutted by evidence that the presumption was inapplicable in the first instance. Second, it is fully consistent with Congress's desire to punish abusive litigation severely, without discouraging, to any increased degree, parties who wish to present serious, even if ultimately unsuccessful, claims. See H. R. Conf. Rep. No. 104-369,

at 39, reprinted in U.S.C.C.A.N. 738. Third, it accords with our prior holdings.

Thus, in *Simon DeBartolo*, where a nonfrivolous claim that presented a novel legal argument was joined to a single frivolous claim, we remanded for consideration of whether the violation was or was not substantial. Under such circumstances, we found that the rebuttable presumption requiring full costs might well not come into play. The nonfrivolous claim in *Simon DeBartolo* involved only questions of law and, hence, was subject to summary dismissal. But the legal questions raised were legitimate and could well have been decided in favor of the plaintiff. See *Simon DeBartolo*, 186 F.3d at 178; see also *Polar Int'l Brokerage Corp. v. Reeve*, 120 F. Supp. 2d 267, 270-71 & n.7 (S.D.N.Y. 2000), aff'd sub nom. *Corroon v. Reeve*, 258 F.3d 86 (2d Cir. 2001). The suit as a whole might, therefore, not be abusive and, accordingly, the presumption of full sanctions might be inappropriate.

As was implicit in *Simon DeBartolo*, however, in such cases, even if no substantial failure existed under the PSLRA, partial sanctions might still be assessable under ordinary Rule 11 standards to punish not the bringing of the whole suit, but only of the frivolous claim. In contrast, if summary judgment had been granted because the nonfrivolous claims were

altogether meritless, and presented no plausible novel legal or factual contentions, the complaint as a whole would properly be viewed as prima facie abusive and, hence, as substantially failing to comply with Rule 11. Such a complaint would not avoid the statutory presumption that a penalty of full fees and costs is appropriate.

* * * *

To summarize: in cases of this sort, the district court must first determine whether frivolous claims in violation of Rule 11 have been brought. If they have, the court must examine whether nonfrivolous claims have been joined and, if so, whether these claims—whatever their number—are of a quality sufficient to make the suit as a whole nonabusive and the Rule 11 violation not substantial. If no such weighty nonfrivolous claims are attached, the statutory presumption applies. The court must then determine whether the violation was de minimis, for, if it was, the presumption is rebutted.[3] Alternatively, financial

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[3] We do not today need to consider what suffices to rebut the presumption under the rubric of de minimis since, as is discussed below, a de minimis finding is out of the question in this case. It is enough to say that de minimis must mean something different from "not substantial," in the sense above described. It

(continued next page)

statements or other relevant evidence may establish that the full sanction award unjustly creates an unreasonable burden on the sanctioned party and that a partial award would not "impose a greater burden on the party in whose favor sanctions are to be imposed." § 78u-4(c)(3)(B)(i). In this situation, too, the presumption is rebutted and full sanctions are not warranted.

The point, though, is that to decide the case before us while making sense of the statute's language and history and cohering with our prior ruling in *DeBartolo*: a) we must give some meaning to

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might, for instance, refer to a minor Rule 11-violative procedural flaw in a suit that, though not in itself otherwise abusive, has no saving merit. Moreover, depending on how stringently the concept of substantiality is ultimately defined in the cases, it is even conceivable, if of, say, twenty counts, one violates Rule 11 while nineteen do not (but are of little or no worth), that a court would deem the violation substantial and yet, echoing the PSLRA's legislative history, find the violation de minimis. And, de minimis could perhaps mean what the concurrer's highly imaginative suggestion has it mean—even though we find it hard to discern a basis for that reading in the text or history of the statute. Finally, one should not exclude the possibility that the seeming tension between substantial and de minimis is just the result of a drafting glitch that occurred because the de minimis defense had to be included for use in cases involving § 78u-4(c)(3)(A)(i).

"substantial," b) we need not, and hence ought not, do more with the meaning of de minimis than say that it must signify something other than just the opposite of "substantial," and c) we should, in order to show that the "de minimis" defense does have a function in the statute, suggest various things that Congress might have intended by the term, leaving for specific cases that raise the issue to decide which meanings would be covered. To do more with "de minimis" is to engage in unnecessary, and hence undesirable, speculation. To do less, with respect to the meaning of "substantial" and its relation to de minimis, is to fail to do what is required to decide this case consistently with our prior decision and the statute's text and context.

This framework is, we believe, consistent with the statutory language, with Congress's intention that the PSLRA "impose upon courts the affirmative duty to scrutinize filings closely" when imposing sanctions for any substantial violation of Rule 11(b), H. R. Conf. Rep. No. 104-369 at 40, reprinted in 1995 U.S.C.C.A.N. 739; see also S. Rep. No. 104-98 at 14, reprinted in 1995 U.S.C.C.A.N. 693, and with the legislature's desire to sanction abusive litigations severely, while not discouraging suits that have potential merit. It is also consistent with the jurisprudence of this Circuit.

II. THE PRESENT SANCTIONS

Applying this statutory analysis to the present case, we find no plausible, nonfrivolous allegation in the complaint against Nu-Tech that saves it from being rightly viewed as an abusive securities lawsuit.[4] In doing so, we do not need to decide precisely how strong the nonfrivolous counts or arguments must be in order to limit sanctions only to the frivolous portions of the complaint. It may be that the presence of claims that survive summary judgment is sufficient. It may be that more is needed. But less may also be enough when, as in Simon DeBartolo, the only nonfrivolous claim was a question of law, and so summary judgment was appropriate, but that claim was deemed to be a novel and plausible one.

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[4] We note that the original complaint included a count brought singly against Winehouse. That count was summarily dismissed, but sanctions with respect to it were denied by the district court and Winehouse did not appeal that denial. Jaroslawicz has at no point in this litigation argued that the presence of the count against Winehouse is sufficient to save his claims against Nu-Tech from being deemed abusive and subject to the PSLRA sanctions. Accordingly, we take no position on whether, in appropriate circumstances, the presence of a nonfrivolous claim against one defendant might keep frivolous claims against another defendant from being viewed as a substantial violation of the PSLRA.

None of that need be decided today. In the case before us, the claims grounded on the first two purchases were frivolous, while the Rule 10b-5 causes of action based upon the last two purchases—though not frivolous—patently lacked merit. The denial of an opportunity to amend the complaint precluded their being deemed frivolous, and barred imposition of Rule 11 sanctions against Jaroslawicz on their account. Because we found it possible that Jaroslawicz could have raised a potentially cognizable claim under the facts of the case with respect to these two claims, we declined to deem them abusive in themselves. But the legal strength, or lack thereof, of the possibly cognizable claim that was not presented in the complaint, and that was itself unlikely to succeed on the merits, cannot suffice to relieve the present complaint from being an unfounded action as a whole. See *Gurary I*, 190 F.3d at 44; *cf. Gurary II*, 235 F.3d at 800 (noting that Gurary misconstrued our holding in *Simon DeBartolo*, in which we found that the plaintiff's 10b-5 action was not frivolous because, unlike Gurary's 10b-5 claims, the existing allegations and facts in the *Simon DeBartolo's* plaintiff's complaint supported each element of a 10b-5 cause of action). It follows that the

complaint substantially violated Rule 11 and that the PSLRA presumption applied.[5]

Jaroslawicz, moreover, has not made out the rebuttal defenses. He argues that his violation was de minimis because two out of the four allegations were deemed nonfrivolous. We need not specify precisely how minimal the frivolous components of a suit must be, in themselves or perhaps in relation to the other parties' conduct, to constitute only a de minimis violation. The legislative history of the PSLRA makes clear that two claims out of four, without any other possible saving grace, is not enough. The violation in the present case was manifestly not de minimis.

Jaroslawicz also argues that the sanctions should be reduced because he recently contracted a disabling

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[5] In dismissing Gurary's state law claim without prejudice, the district court did not make a specific factual finding with respect to whether this nonfederal allegation in the complaint was frivolous. Because Jaroslawicz has not raised before this court the argument that his state law allegation suffices to make the complaint as a whole nonabusive, we need not consider this possible contention. See *Krumme v. Westpoint Stevens Inc.*, 238 F.3d 133, 142 (2d Cir. 2000). Accordingly, we decline to decide whether the presence of a state law claim, if it has sufficient merit, may preclude a finding of a substantial failure to comply with Rule 11 in a federal securities action.

disease and operates a small law firm. In the view of the district court, these "facts"—because Jaroslawicz refused to submit financial statements, medical bills, and other documents which would allow the court to assess the impact of his health problems—did not establish that the sanction would create an unreasonable burden. On appeal, Jaroslawicz argues that he should not have to endure an invasion of his privacy in order to receive relief from the burden created by the sanctions. But, once the presumption applies, Jaroslawicz bears precisely that burden, and he must be willing to offer some financial or other like statements, reflecting the claimed impact of his illness and the consequences of imposing the sanctions award, if that is to be the basis of his rebuttal. This he has not done.

III. RECOVERY OF EXPENSES INCURRED IN SEEKING THE SANCTIONS

One final issue requires attention. In the present appeal, Jaroslawicz argues, for the first time, that the district court erred by including in the award the legal fees and costs incurred by Nu-Tech as a result of the sanctions application itself. These include the expenses

for work related to the three decisions issued below as well as the two earlier proceedings in this Court.

Unless manifest injustice will result from refusing to consider the newly raised issue, it is not properly before this panel. *Mycak v. Honeywell,* 953 F.2d 798, 803 (2d Cir. 1992); see also *Gurary I,* 190 F.2d at 44. If Jaroslawicz were correct, the sanction award would be reduced by approximately $28,000. In light of his multiple opportunities to raise the issue previously, and the limited monetary difference, the point Jaroslawicz now advances does not raise concerns of manifest injustice.

Even if we were to consider the merits of this claim, it is unlikely that Jaroslawicz would prevail. We are remanding for imposition of sanctions pursuant to subsection (c)(3)(A)(ii), which states that under the statutory presumption, the sanction shall be the "reasonable attorneys' fees and other expenses incurred in the action." 15 U.S.C. § 78u-4(c)(3)(A)(ii) (emphasis added). As a result, the statutory language can support a reading that permits the fees and expenses incurred in pursuing the sanctions to be included in the award. As Nu-Tech argues, the present lengthy litigation exemplifies how costly pursuing sanctions may become, particularly in the case of strike suits. Were sanctions limited to recovering only the costs and fees

for the initial action, which is often dismissed on the merits early in the litigation process, many defendants would fail to submit sanctions applications or to pursue them on appeal.

Such a result would undermine the PSLRA's statutory purpose. Unlike the fee-shifting provisions in other statutes that are there to promote litigation, see, e.g., 42 U.S.C. §§ 1988(b), 2000e-5(k), Congress passed the statutory presumption in the PSLRA sanctions scheme in order to encourage "defendants to fight abusive claims," see S. Rep. No. 104-98, at 4, reprinted in 1995 U.S.C.C.A.N. 683, and to compensate wholly victims of frivolous litigation, see H. R. Conf. Rep. No. 104-369, at 39, reprinted in 1995 U.S.C.C.A.N. 738 ("Finally, courts have been unable to apply Rule 11 to the complaint in such a way that the victim of the ensuing lawsuit is compensated for all attorneys' fees and costs incurred in the entire action." (emphasis added)). The strict statutory presumption against plaintiffs is limited to those securities fraud cases that are unfounded and abusive. Once the presumption is triggered and is not rebutted, however, it seems most likely that Congress meant for the defendant to receive fees and costs incurred in seeking sanctions pursuant to

§ 78u-4(c)(3)(A)(ii), including all reasonable expenses related to appellate proceedings.[6]

CONCLUSION

We hold that Jaroslawicz's complaint, which contains frivolous claims that were summarily dismissed and no claims of such merit as to make his suit as a whole nonabusive, subjects him to full sanctions, including appellate expenses. We hold further that the presence of some nonfrivolous claims in an otherwise frivolous complaint is not sufficient,

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[6] If the statutory presumption is overcome, however, the district court "shall" only impose those sanctions that it "deems appropriate" pursuant to Rule 11. § 78u-4(c)(3)(C). In such cases, the award is likely to be limited by the existing practice under Rule 11 which prohibits the inclusion of fees for appellate work related to the Rule 11 sanctions application when those sanctions are intended to award fees and expenses to the moving party. See *Cooter & Gell v. Hartmarx Corp., 496 U.S. 384, 407, 110 L. Ed. 2d 359, 110 S. Ct. 2447 (1990)* (finding that Rule 11 and Rule 38 of the Federal Rules of Appellate Procedure "are better read together as allowing expenses incurred on appeal to be shifted onto appellants only when those expenses are, themselves, caused by a frivolous appeal, and not merely because a Rule 11 sanction upheld on appeal can ultimately be traced to a baseless filing in district court").

standing alone, to establish that either the violation of Rule 11 was de minimis or that the sanctions would create an unreasonable burden, for purposes of overcoming the statutory presumption of the PSLRA.

The judgment of the district court is, therefore, VACATED and REMANDED for further proceedings consistent with this opinion.

JOHN M. WALKER, JR., Chief Judge, concurring:

I concur in the majority's judgment to vacate and remand in this case. I write separately, however, because there is no need to look beyond the text and structure of the statutory provisions at issue to ascertain their meaning.

Because a statute's text embodies the duly enacted law and the final and authoritative expression of the legislative will, our principles of statutory construction emphasize the primacy of the statutory text. See *S.E. Cmty. Coll. v. Davis*, 442 U.S. 397, 405, 60 L. Ed. 2d 980, 99 S. Ct. 2361 (1979) ("It is elementary that the starting point in every case involving construction of a statute is the language itself.") (alteration, citation, and internal quotation marks omitted). In interpreting Congress's statutory commands, courts should look not

simply to the text of the particular provision at issue but also to the framework of the statute and the text of related provisions which provide the context for it. See *K Mart Corp. v. Cartier, Inc.*, 486 U.S. 281, 291, 100 L. Ed. 2d 313, 108 S. Ct. 1811 (1988) (stating that "in ascertaining the plain meaning of the statute, the court must look to the particular statutory language at issue, as well as the language and design of the statute as a whole"). Read in their statutory setting, the provisions of the PSLRA are clear enough to resolve the issues raised by this case.

The majority arrives at its interpretation by what I consider to be less reliable means. Summarily concluding that the text of the statute does not make clear how to treat complaints that raise both frivolous and non-frivolous claims, Maj. Op., supra, at [14], the majority begins its interpretive analysis by inquiring into the underlying purpose of the statute, as revealed by the legislative history, *Id.* at [14-18]. This approach seems particularly ironic here given the majority's ultimate conclusion that this case raises "a problem that Congress did not seem to have in mind." *Id.* at [17]. While the legislative history does refer to the general and conflicting policies that were on the minds of some of the congressional committee members, it offers virtually no guidance as to how these vague and

general policies should be implemented in particular cases, much less as to how the presumption and rebuttal provisions at issue here should be interpreted.

I. THE INVOCATION OF THE PRESUMPTIVE AWARD

This appeal concerns the proper award of mandatory sanctions under the PSLRA for a complaint that asserts frivolous claims. The statute provides that

> the court shall adopt a presumption that the appropriate sanction—(i) for failure of any responsive pleading or dispositive motion to comply with any requirement of Rule 11(b) . . . is an award . . . of the reasonable attorneys' fees and other expenses incurred as a direct result of the violation; and (ii) for substantial failure of any complaint to comply with any requirement of Rule 11(b) . . . is an award . . . of the reasonable attorneys' fees and other expenses incurred in the action.

15 U.S.C. § 78u-4(c)(3)(A). The invocation of the presumption in this case thus turns on whether Gurary's complaint "substantially failed" to comply with Rule 11(b) within the meaning of subsection (ii).

I easily conclude that Gurary's complaint substantially failed to comply with Rule 11(b),

notwithstanding the existence of non-frivolous claims. Where, as here, the only potentially non-frivolous claims surfaced, not in the complaint, but later on in an appeal from the motion to dismiss, the complaint substantially (and perhaps wholly) failed to comply with Rule 11(b). Indeed, unless the statutory presumption is to be given no effect, no other conclusion seems possible.

Thus I disagree with the majority's contention that the mixture of frivolous and non-frivolous claims in this case raises an issue sufficiently difficult to warrant departure from the text of the statute. Moreover, my conclusion would be the same even if the late-emerging non-frivolous claims had been in the complaint.

The majority discerns a gap in the statutory scheme, not by looking to the text of the statute, but by viewing this language through the filter of the legislative history. According to the majority, the statute is incomplete because Congress adopted the "substantial failure" language proposed in Judge Scirica's letter but did not address his concern that an additional modification was necessary to indicate the consequences of a minor offense. Maj. Op., supra, at [16-17]. This interpretation of the legislative history leads the majority to conclude that Congress "did not

define clearly what was meant by a 'substantial failure.'" *Id.* at [17]. However, reliance on Judge Scirica's letter is not necessary because the text is clear; indeed, this approach is troubling for a number of other reasons.[1]

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[1] In referring to Judge Scirica's letter, the majority cites to a Senate debate, not on the "substantial failure" language, but on the level of particularity required in the PSLRA's heightened pleading standards. See 141 Cong. Rec. S19037-02, S19044-45 (Dec. 21, 1995). Senator Domenici inserted the letter in the record to justify the fairness of this pleading standard in light of President Clinton's veto of a prior version of the bill and in response to a question raised by Senator Specter. *Id.* at S19044 ("The reason we put in 'state with particularity the facts giving rise to a strong inference' is because that is what Judge Scirica, speaking on behalf of the Judicial Conference, asked Congress to do."). After uncovering this comment and the Scirica letter in a remarkable piece of sleuthing, the majority apparently deduces from the comment and the letter, which also recommends the adoption of "substantial" in the presumption, *Id.* at S19045, that "Congress adopted Judge Scirica's 'substantial failure' language," Maj. Op., supra, at [17]. This bit of drafting lore, which leads the majority to endow the letter with such authority that it can ascribe Judge Scirica's view that a "gap" exists within the meaning of "substantial failure" as somehow binding Congress, is irrelevant as an interpretive matter. Congress passed the provision as drafted, not Judge Scirica's letter, which no doubt few, if any, legislators read. Apart from confusion and misdirection, such use of legislative history raises deeper concerns: the predictability and transparency of the law.

Whatever might have led the drafters to adopt the term "substantial," the commonly understood meaning of this term is plain enough. Terms like "substantial" and the related term "material" are common coin of the legal realm. This is particularly true in the context of securities fraud, which is defined in Rule 10b-5 in terms of the "materiality" of the allegedly fraudulent statement, see *17 C.F.R. § 240.10b-5(b)* (making unlawful "any untrue statement of a material fact or [the omission of] a material fact").

Courts and attorneys would have little difficulty understanding that the "substantial failure" language requires an inquiry into whether the complaint's Rule 11(b) violations make the complaint as a whole "essentially," "without material qualification," "in the main," or "materially" frivolous. Black's Law Dictionary 1281 (5th ed. 1979) (defining substantially). It would also be readily understood that this inquiry requires an evaluation of the factors identified by the majority, that is, the context in which the non-frivolous claims were asserted and the quality of those claims. Maj. Op., supra, at [21-22, 24]. Obviously, the legislature cannot draft provisions that account for every situation that might arise, and one can foresee situations in which a finding concerning "substantial failure" would be a tough call. But the difficulty of

applying the provisions in some cases does not make the statute unclear. To the contrary, given the case-specific inquiry prescribed by Congress, and the wide range of scenarios likely to arise in this context, see *Id.* at [17-18], I fail to see how Congress could have spoken more clearly.

The text of the PSLRA also leads me to easily conclude that the presumptive award is for the full amount of expenses and not, as appellant contends, for only those costs incurred as a result of the frivolous claims. The presumptive award is for "the reasonable attorneys' fees and other expenses incurred in the action." 15 U.S.C. § 78u-4(c)(3)(A)(ii). The "in the action" language, which does not distinguish between any parts of the action, plainly commands an award for the entire amount of expenses. This is also made evident from a consideration of the parallel presumptive award provision, the only other subsection commanding a presumptive award. In that provision, the PSLRA prescribes the approach advocated by appellant, but limits it to responsive pleadings and dispositive motions. *Id.* § 78u-4(c)(3)(A)(i) (providing for an award "for failure of any responsive pleading or dispositive motion to comply with any requirement of Rule 11(b) . . . of the reasonable attorneys' fees and other expenses incurred

as a direct result of the violation") (emphasis added). To conflate the two separate provisions, as appellant would in effect have us do, would therefore contravene the oft-repeated canon of statutory construction whereby courts are enjoined to give force and effect to all of a statute's provisions and to avoid rendering any of them superfluous. See *Auburn Hous. Auth. v. Martinez*, 277 F.3d 138, 145-46 (2d Cir. 2002) (collecting cases).

II. THE DE MINIMIS REBUTTAL PROVISION

The key to interpreting the de minimis rebuttal provision can again be found in the statute that Congress actually passed. The entire rebuttal provision reads as follows:

> The presumption described in subparagraph (A) may be rebutted only upon proof by the party or attorney against whom sanctions are to be imposed that—(i) the award of attorneys' fees and other expenses will impose an unreasonable burden on that party or attorney and would be unjust, and the failure to make such an award would not impose a greater burden on the party in whose favor sanctions are to be imposed; or

(ii) the violation of Rule 11(b) of the Federal Rules of Civil Procedure was de minimis.

15 U.S.C. § 78u-4(c)(3)(B).

When the de minimis rebuttal provision, subsection (ii), is viewed in its statutory context, the problem that so bedevils the majority—avoiding the "paradoxical result . . . that the presumption is rebutted by evidence that the presumption was inapplicable in the first instance," Maj. Op., supra, at [22]—becomes more manageable. In particular, by viewing the de minimis provision in the context of the statute as a whole and the subsection in which it has been placed, one avoids the trap of considering the provision solely in terms of frivolous versus non-frivolous counts in a complaint. I suspect that the majority's concentration on claims stems from its preoccupation with the legislative history, specifically the reference in the Conference Committee Report to the de minimis provision in connection with a complaint in which only one of twenty counts is frivolous. See *Id.* at [19, 24 n.3].

To be sure, evaluating complaints on a claim-by-claim basis may be a proper application of the de minimis provision in some cases. But it is not the whole picture. Indeed, when the de minimis provision is viewed in light of the design of the statute, it is evident that that provision rebuts the presumption of

mandatory sanctions for all of the Rule 11(b) violations listed in subsection (A); these violations may occur not only in complaints but also responsive pleadings and dispositive motions. In the latter cases, where "the failure" of a responsive pleading or dispositive motion to comply with "any requirement of Rule 11 (b)" invokes the presumption, the majority's claim-based approach is largely, if not entirely, irrelevant.

That a broader understanding of de minimis is appropriate is further indicated by the other rebuttal provision, (B)(i). This rebuttal provision directs the court to weigh the equities of imposing the presumptive mandatory sanctions in terms of whether the award would impose "an unreasonable burden" and would be "unjust" for the sanctioned party, on the one hand, and whether the non-imposition of such an award would not impose "a greater burden" on the non-sanctioned party, on the other. As the majority correctly found, this inquiry is concerned with the fairness of making the sanctioned party pay and its relative ability to do so, given financial or other hardship, and the non-sanctioned party's need to be paid. *Id.* at [20]. Such a holistic approach is equally applicable to both responsive pleadings and dispositive motions that simply fail to comply with some

requirement of Rule 11(b) as well as to complaints that substantially fail to comply.

The de minimis rebuttal provision, subsection (B)(ii), should likewise be read to require that the Rule 11(b) violations be de minimis in the context of the case as a whole. Following the general pattern of its sister rebuttal provision, the de minimis rebuttal provision prescribes the weighing of the sanctioned party's misconduct in, for example, filing a substantially frivolous complaint or a responsive pleading or dispositive motion that violates Rule 11(b), against the rest of that party's conduct in the action and the conduct of the non-sanctioned party. Whereas the first rebuttal provision is primarily concerned with whether the party can pay, the de minimis provision is primarily concerned with whether that party should pay.

The de minimis provision, then, allows the rebuttal of the presumption where the presumed mandatory award would be manifestly and egregiously unfair because the sanctioned party's misconduct in a part of the case, the filing of a sanctionable pleading or a dispositive motion, is de minimis in light of that party's conduct and the non-sanctioned party's misconduct considered in the totality of the circumstances surrounding the action. Under this provision, the presumption would be rebutted, for

example, where a sanctionable pleading or dispositive motion was met with even worse misconduct by the opposing party or attorney in the other phases of the litigation. It would also be invoked where, in the context of a substantially frivolous complaint, a non-frivolous claim, whether joined in the complaint with many frivolous claims or added later in the action, turned out to win a large money judgment because of defendant's gross misconduct in the events underlying the case.

Because of the heightened standards imposed by the rebuttal provision, this reading would not erode the protections provided by the presumption requiring mandatory sanctions for baseless complaints and abusive responsive pleadings and dispositive motions. The de minimis standard means that for the presumption to be rebutted, the equities must weigh very heavily in the favor of the party or attorney against whom sanctions are sought; the sanctionable party's misconduct must pale in significance or culpability in light of the other party's. When applied with its due stringency, the exception would not swallow the rule.

I fear the majority's proposed reading of the de minimis provision as it affects complaints fails to give it a meaning that is sufficiently different from the

substantial failure provision to harmonize these two provisions. I have difficulty imagining the circumstances under which the majority's examples of possible de minimis violations—a "minor . . . procedural flaw in a suit that . . . [is] not in itself otherwise abusive" or a complaint in which only one of twenty counts violates Rule 11(b), Maj. Op., supra, at [24 n.3]—would be found to be complaints (assuming the first example involved a complaint) that substantially failed to comply with Rule 11(b) in the first place. The latter example, which the majority has taken from the legislative history, *Id.* at [19, 24 n.3], seems to me an instance of misusing legislative history by following it even when it leads to a reading that would render one of the statute's provisions meaningless.

In this case, I agree with the majority's conclusion that appellant has failed to rebut the presumption under the "de minimis" rebuttal provision or, for that matter, the "unreasonable burden" and "unjust" rebuttal provision. Here, too, the answer can be gleaned without much difficulty from the plain language of the statute. The PSLRA allows the presumption to be rebutted only where the party facing sanctions provides "proof" that the award would be an unreasonable burden on him and would be unjust or

that the violation was de minimis. *15 U.S.C. § 78u-4*(c)(3)(B). As the majority points out, the ordinary meaning of unreasonable burden and its placement in the statute indicate a requirement of proof of some financial or similar hardship. Maj. Op., supra, at [20-21]. By failing to produce any evidence of such hardship, appellant failed to satisfy this requirement and the district court erred by finding the statutory presumption rebutted on this basis. Similarly, appellant has failed to produce evidence that his substantially frivolous complaint was de minimis, however that provision is interpreted.

III. FEES AND EXPENSES INCURRED IN PURSUING SANCTIONS

With respect to the final issue raised by this appeal, I agree with the majority that "the statutory language can support a reading that permits the fees and expenses incurred in pursuing the sanctions to be included in the award." *Id.* at [29]. Such a result follows from both the ordinary meaning of the text—which provides for an award of "the reasonable attorneys' fees and other expenses incurred in the action," *15 U.S.C. § 78u-4*(c)(3)(A)(ii) (emphasis added)—as well as from the meaning ascribed to similar language as used in similar

statutes. See Black's Law Dictionary 26 (5th ed. 1979) (defining action to "include[] all the formal proceedings in a court of justice attendant upon the demand of a right made by one person of another in such court, including an adjudication upon the right and its enforcement or denial by the court"); cf. *Comm'r, INS v. Jean*, 496 U.S. 154, 161-62 (1990) (finding that the Equal Access to Justice Act, 28 U.S.C. § 2412(d)(1)(A), which provides for an award of "fees and other expenses . . . incurred by that party in any civil action," includes an award of expenses incurred in seeking fees); *Id.* at 159 (noting that the language "in any civil action" does not refer "to separate parts of the litigation, such as discovery requests, fees, or appeals").

Accordingly, I respectfully concur in the judgment.

Appendix H

Order Denying Rehearing and Denying Rehearing En Banc of Gurary III

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, Foley Square, in the City of New York, on the 17th day of October two thousand two.

Mordechai Gurary,

Plaintiff-Appellant-
Cross-Appellee,

v.

Docket Nos.
01-7969(L)
(01-9000) (XAP)

Nu-Tech Bio-Med, Inc.,

Defendant-Appellee-
Cross-Appellant

Winehouse,

Defendant

A petition for panel rehearing and a petition for rehearing en banc having been filed herein by the appellant-cross-appellee Gurary.

Upon consideration by the panel that decided the appeal, it is Ordered that said petition for rehearing is DENIED.

It is further noted that the petition for rehearing en banc has been transmitted to the judges for the court in regular active service and to any other judge that

heard the appeal and that no such judge has requested that a vote be taken thereon.

FOR THE COURT
ROSEANN B. MACKECHNIE, Clerk
By: S/_____
Arthur M. Heller,
Administrative Attorney

[stamp:]

United States Court of Appeals
Filed
October 17, 2002
Roseann B. Mackechnie, Clerk
Second Circuit

Appendix I

Decision of the United States Court of Appeals for the Eleventh Circuit in Oxford

No. 99-11690, No. 00-13220

OXFORD ASSET MANAGEMENT, LTD, et al

Plaintiff- Appellant,

v.

MICHAEL JAHARIS, DANIEL M. BELL, et al.

Defendants- Appellees

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF FLORIDA

DECIDED JULY 16, 2002

OPINION OF THE COURT

GARWOOD, Circuit Judge:

In this securities action (our No. 99-11690), plaintiff-appellant Oxford Asset Management, Ltd. (Oxford) appeals the dismissal of its 1933 Act claims.[1] We Affirm.

Oxford also appeals (in our No. 00-13220) the district court's award of $520,091.82 in legal fees to the Kos and Underwriter defendants. We affirm in part, reverse in part, and vacate and remand.

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[1] The motions to dismiss were made by defendants-appellees Kos Pharmaceuticals, Inc., Michael Jaharis, Daniel M. Bell, Duncan H. Cocroft, Juan F. Rodriguez, Robert E. Baldini, John Brademas, Steven Jaharis, Louis Lasagna, Mark Novitch, Frederick B. Whittemore (collectively, Kos Defendants) and Cowen & Company, Donaldson Lufkin & Jenrette, Salomon Smith Barney Holdings, Inc., SBC Warburg Dillon Read, Inc. (collectively, Underwriter Defendants).

FACTS AND PROCEEDINGS BELOW

1. APPEAL OF THE DISMISSAL (NO. 99-11690)

Kos Pharmaceuticals, Inc. (Kos) is a pharmaceutical company that develops and markets prescription drugs. Kos completed an initial public offering of its common stock on March 12, 1997, selling 4,772,500 shares at $15 per share. From October 21, 1997, to October 24, 1997, Kos completed a secondary offering of its common stock. On October 21, 1997, Kos filed the prospectus and registration statement for the secondary offering with the Securities and Exchange Commission. The offering price was $42.75. A total of 3,625,000 shares were sold in the secondary offering. Kos sold 1,085,000 shares. Michael Jaharis, Kos's founder, majority shareholder and chairman, sold 2,390,000 shares. Daniel Bell, Kos's president and chief executive officer, sold 150,000 shares.

Kos's only prescription drug product that was publicly available at the time of the secondary offering was an extended release niacin preparation called Niaspan. Niaspan was approved by the Food and Drug Administration in July 1997. Kos began shipping Niaspan to wholesalers in August 1997, and its sales force began detailing physicians in September 1997. On

November 12, 1997, a Salomon Brothers analyst, Robert Uhl, released a report in which he slashed Kos's projected revenue for 1998 by half, from $92 million to $46 million, and changed the rating of Kos's stock from buy to hold. The next day, the price of Kos's stock plummeted from $30-15/16 to $16 9/16 per share. Uhl's report was premised on estimates[2] of the numbers of new and refill prescriptions for Niaspan during the first eight weeks that Kos's sales force marketed Niaspan. Uhl's conclusions were based on the assumption (that he and many other pharmaceutical analysts apparently share) that the number of new prescriptions filled during the eighth week of a new prescription drug product's initial marketing is particularly predictive of the market success the product will enjoy. The eighth week of Niaspan's marketing ended on October 31, 1997. Uhl stated that to achieve the original $92 million revenue projection, 5,000 new prescriptions of Niaspan during the eighth week were needed. IMS America estimated that only 708 new prescriptions for Niaspan were filled during the eighth week. Uhl explained that, considering the small size of Kos's sales force and their program of providing sample packs (which contain a three-week supply of Niaspan) to physicians, he would

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[2] These estimates were provided by IMS America.

have been satisfied with 4,000 new prescriptions during week eight. Uhl concluded by noting that due to the sampling program and the anti-niacin bias of many physicians, Niaspan could be the first drug for which the "initial weekly prescriptions are not indicative of the product's ultimate success."

Kos's fifty-two page prospectus, filed October 21, 1997, explained the many risks of investing in Kos, among them: 1) "The Company's ability to successfully commercialize Niaspan will depend significantly on the acceptance of Niaspan by physicians and their patients"; 2) Niaspan has been designed to minimize the severity of the side effect of flushing, but most patients taking Niaspan will experience flushing and "there can be no assurance . . . that patients using Niaspan will not suffer episodes of flushing that they consider intolerable."; 3) Kos's clinical trials indicate that less than one per cent of patients taking Niaspan experience clinically significant elevations in liver enzymes, but physicians have historically been reluctant to prescribe niacin preparations because of such risk and it is possible that the actual incidence of hepatotoxicity will exceed one per cent; 4) Kos has fewer marketing resources than its competitors, a smaller sales force, and "limited" marketing experience, which could prevent Niaspan from achieving "market

acceptance"; 5) "during the initial months following the launch of Niaspan, many physicians may start only a limited number of selected patients on Niaspan"; 6) physicians' anti-niacin bias combined with the distribution of three-week starter packs (which are dispensed without prescription) may result in only a modest increase in Niaspan prescriptions for the first three to six months of its marketing; and 7) since its inception, Kos had lost about $80 million and there can be no assurance that Kos will ever achieve profitability.

On August 10, 1998, Oxford and Lowey, Dannenberg & Knapp, P.C. (Lowey) filed this suit in the northern district of Illinois. On December 7, 1998, the action was transferred to the southern district of Florida. Plaintiffs brought this action as a proposed class action.[3] Oxford proposed to represent plaintiffs that purchased Kos stock in the secondary offering. Lowey proposed to represent plaintiffs that purchased Kos stock on the open market between July 29, 1997, and November 13, 1997. The complaint alleged violations of sections 11(a), 12(a)(2) and 15 of the 1933 Act, 15 U.S.C. §§ 77k(a), 77l(a)(2) and 77o, sections 10(b) and 20(a) of the 1934 Act, 15 U.S.C. §§ 78j(b) and 78t(a),

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[3] The district court's dismissal of the complaint mooted the class certification issue. Thus, that issue was not resolved.

and Rule 10(b)(5), 17 C.F.R. § 240.10b-5. The complaint also alleges common law fraud, negligent misrepresentation and breach of fiduciary duty. All of the causes of action in plaintiffs' original complaint are based on defendants' alleged material misrepresentations and omissions (in press releases, the prospectus, the registration statement, and other SEC filings) concerning the safety, efficacy, tolerability and sales volume of Niaspan. On January 7, 1999, the Kos defendants moved to dismiss the complaint pursuant to Fed. R. Civ. P. 12(b)(6). The Underwriter defendants so moved on February 8, 1999. At the dismissal hearing, the plaintiffs advanced a new basis for recovery, namely that the prospectus should have disclosed the first six weeks of IMS America's estimates of Niaspan's prescription volume. In the interests of justice, the district court considered this as an amended claim. On May 19, 1999, the district court granted the motions to dismiss, holding that the omission of the prescription volume data was immaterial as a matter of law and that plaintiffs' allegations as to the safety, efficacy, tolerability and sales volume of Niaspan were mere legal conclusions masquerading as facts. On August 3, 1999, the district court dismissed the complaint with prejudice.

Oxford appeals the dismissal of its 1933 Act and the common law claims of fraud and negligent misrepresentation, but admits that dismissal of the common law claims was proper if dismissal of the federal claims was proper. Oxford does not appeal the dismissal of its 1934 Act claims. Lowey, which was not named as a plaintiff in the 1933 Act counts, does not appeal to this Court.

2. APPEAL OF THE ATTORNEYS' FEES AWARD (NO. 00-13220)

On July 6, 1999, the Kos defendants moved for sanctions pursuant to the Private Securities Litigation and Reform Act (PSLRA) and Rule 11. On July 16, 1999, the Underwriter defendants so moved. On January 31, 2000, the district court granted the motions for sanctions, finding that the plaintiffs were deliberately indifferent to the lack of factual support for the allegations in the complaint and that, therefore, the complaint was objectively frivolous. On May 22, 2000, the district court awarded $502,576.82 in attorney's fees to the defendants. On June 7, 2000, the district court clarified its earlier order and increased the award to $520,091.82. Oxford appeals the district court's grant of defendants' motions for sanctions and its award of attorney's fees to defendants.

3. CONSOLIDATION

This Court subsequently granted Oxford's motion to consolidate the appeals for oral argument.

DISCUSSION

I. STANDARD OF REVIEW

This court reviews de novo the dismissal of a complaint pursuant to Rule 12(b)(6). *Harris v. Ivax Corp.*, 182 F.3d 799, 802 (11th Cir. 1999). The plaintiff's factual allegations are accepted as true. *South Florida Water Management Dist. v. Montalvo*, 84 F.3d 402, 406 (11th Cir. 1996). Dismissal is not appropriate unless it is plain that the plaintiff can prove no set of facts that would support the claims in the complaint. *Id.* However, conclusory allegations, unwarranted deductions of facts or legal conclusions masquerading as facts will not prevent dismissal. *Id.*; *Fernandez-Montes v. Allied Pilots Ass'n*, 987 F.2d 278, 284 (5th Cir. 1993).

II. DISTRICT COURT'S CONSIDERATION OF DOCUMENTS ATTACHED TO THE KOS DEFENDANTS' MOTION TO DISMISS

In resolving the defendants' motions for dismissal, the district court considered the prospectus, which was attached to the complaint; Kos's 10-Q for the period ending September 30, 1997, which was required to be and was actually filed by Kos with the SEC; the Uhl report, quoted in the complaint; a July 29, 1997, press release, quoted in the complaint; a November 12, 1997, press release, quoted in the complaint; a 1996 article about Niaspan, quoted in the complaint; and the Niaspan package insert. All of these documents were attached to the Kos defendants' motion to dismiss. Oxford contends that consideration of such "matters outside of the pleadings" was improper on a motion to dismiss, and that the district court should have converted the motion to dismiss into one for summary judgment. We disagree. In a motion to dismiss a securities action, a court may consider the contents of public disclosure documents which are required to be filed with the SEC and are actually so filed. *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1277-78 (11th Cir. 1999). The documents may only be considered to show their contents, not to prove the truth of matters asserted

therein. Neither do we find error in the district court's use of the Uhl report, the press releases or the 1996 article. See *Harris v. Ivax Corp.*, 182 F.3d 799, 802 n.2 (11th Cir. 1999). The package insert for Niaspan was not referred to in the complaint, but the district court reasoned that its contents could be judicially noticed because "it is a matter of public record (part of the FDA public file), is included in every package of Niaspan, and also listed in the Physician's Desk Reference." The district court specifically stated it was not accepting the facts asserted in the insert as true, and appears only to have used it to show the bare existence of a clinical study which stated that Niaspan could increase HDL cholesterol by 32%. We find no error in this.

III. SECTION 11 CLAIMS

Section 11(a) of the 1933 Act, 15 U.S.C. § 77k, provides a cause of action to purchasers of securities where: "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . ." Section 11 extends liability to every person who signed the registration statement, the issuer's directors, and every underwriter. Section 12(a)(2) of the 1933 Act, 15

U.S.C. § 77l, imposes liability upon one who sells a security "by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . . ." Section 15 of the 1933 Act, 15 U.S.C. § 77o, extends Section 11 and 12 liability to persons who control entities liable under those sections. Thus, to state a claim under any of these sections, Oxford must properly allege a material misrepresentation or a material omission.

A. Omission of Prescription Volume Data

To avoid dismissal of a section 11 omission claim, plaintiffs must properly allege: 1) the prospectus contained an omission; 2) the omission was material; 3) defendants were under a duty to disclose the omitted material information; and 4) that such information existed at the time the prospectus became effective. *Cooperman v. Individual, Inc., 171 F.3d 43, 47 (1st Cir. 1999).* The complaint (as amended at oral argument before the district court) alleges that: 1) Kos possessed the first seven weeks of Niaspan's prescription volume history; 2) this information was material; 3) issuers have a duty to disclose all material information in the prospectus; and 4) the absence of the prescription

volume information rendered the prospectus misleading.

1. Materiality

The district court assumed that Kos was in possession of "several weeks" of information, but held that, because Uhl based his conclusions almost entirely on the number of new prescriptions for Niaspan filled during the eighth week (which occurred after the close of the offering), the partial, preliminary information Kos possessed was not material. The district court also noted the prospectus's mention of several obstacles to the market acceptance of Niaspan, including a specific warning that Niaspan's sales may grow slowly during the first three to six months of its marketing.

The test of materiality is well known. "To fulfill the materiality requirement 'there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.'" *Basic Incorporated v. Levinson*, 485 U.S. 224, 108 S. Ct. 978, 983, 99 L. Ed. 2d 194 (1988) (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 96 S. Ct. 2126, 2132, 48 L. Ed. 2d 757 (1976)). The trier of fact usually decides the issue of materiality. *Cooperman*, 171 F.3d at 48-49. Only if the lack of importance of the omission is so plain that reasonable minds cannot differ

thereabout is it proper for the court to pronounce the omission immaterial as a matter of law. *Ganino v. Citizens Utilities Co.*, 228 F.3d 154, 161-64 (2nd Cir. 2000); *Cooperman*, 171 F.3d at 49.

We are willing to assume, at the dismissal stage, that Kos possessed whatever prescription volume information existed. We do not know how quickly the IMS America estimates became available, but some delay or lag time seems inevitable. The prospectus was filed October 21, 1997. Oxford purchased its stock on October 24, 1997, the last day of the seventh week of Niaspan's marketing. Thus, Oxford's assertion that Kos possessed seven weeks of data is literally unbelievable. Even though Kos probably did not possess even six weeks of information, for dismissal purposes we will assume that it did.

Realizing that no argument could be made that Kos possessed the critical eighth week of information, Oxford characterizes the partial data as a material trend. During the sixth week, there were 498 new prescriptions for Niaspan. Oxford's point appears to be that, considering the first six weeks of data, it was very unlikely that Niaspan would achieve the Uhl goal of 4,000 to 5,000 new prescriptions per week, and therefore a reasonable investor would consider the total mix of information significantly altered by the data's

inclusion. The district court correctly observed that the prospectus explains the several reasons why Niaspan may start more slowly than other drugs. However, the immateriality of the six weeks of prescription information is arguably not so plain that reasonable minds could not differ about it. Accordingly, we will assume for purposes of the motion to dismiss that the six weeks of prescription volume information was material.

2. Duty to Disclose

Oxford asserts three bases for Kos's duty to disclose the prescription data in the prospectus: 1) a general duty to disclose, in the prospectus, all information material to the offering; 2) Item 303(a)(3)(ii) of regulation S-K, *17 C.F.R. § 229.303(a)(3)(ii)*; and 3) the omission of the prescription data rendered the prospectus materially misleading. We address eachof these arguments in turn.

(a.) General Duty

Oxford first argues that issuers have a duty to disclose, in the prospectus, all information material to the offering. We disagree. Section 11(a) only makes actionable the omission of a material fact required to be stated in the prospectus or necessary to make the statements in the prospectus not misleading. To hold

that section 11(a) imposes liability unless the prospectus includes all material facts is simply to wholly ignore and render superfluous that section's qualifying language "required to be stated therein or necessary to make the statements therein not misleading." This we may not do. Moreover, considering that materiality will usually be an issue for the trier of fact, to require all material information to appear in the prospectus would, like setting the threshold for materiality too low, result in registrants burying the "shareholders in an avalanche of trivial information-a result that is hardly conducive to informed decisionmaking." *Basic Inc. v. Levinson,* 485 U.S. 224, 108 S. Ct. 978, 983, 99 L. Ed. 2d 194 (1988) (quoting *TSC Industries, Inc. v. Northway, Inc.,* 426 U.S. 438, 96 S. Ct. 2126, 2132, 48 L. Ed. 2d 757 (1976)). We join with the First Circuit in recognizing that the "mere possession of material nonpublic information does not create a duty to disclose it" and that the duty question is properly stated as "whether the defendants had a specific obligation to disclose information of the type that the plaintiffs complain was omitted from the registration statement and prospectus." *Shaw v. Digital Equipment Corp.,* 82 F.3d 1194, 1202 (1st Cir. 1996). If the prospectus contains all of the material information specifically required by the securities laws, does not

contain an untrue statement of a material fact and if the statements therein are not materially misleading in any respect, there has been no material misrepresentation or material omission.

(b.) Item 303(a)(3)(ii)

In its reply brief, Oxford asserts, for the first time, that disclosure of the prescription volume estimates was required by Item 303(a)(3)(ii) of regulation S-K, 17 C.F.R. § 229.303(a)(3)(ii). While we need not consider this untimely argument, even if we did consider it, it, too, would fail.

Other circuits have considered whether or in what circumstances Section 11 liability may be premised upon the failure to disclose information required by Item 303. See *Oran v. Stafford,* 226 F.3d 275, 288 (3d Cir. 2000); *Steckman v. Hart Brewing Inc.,* 143 F.3d 1293, 1296 (9th Cir. 1998). However, we need not explore those questions because we conclude that in any event Item 303 did not require that the prospectus disclose the first six weeks' prescriptions.

Item 303(a)(3)(ii) requires registrants to:

> "Describe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing

> operations. If the registrant knows of events that will cause a material change in the relationship between costs and revenues (such as known future increases in costs of labor or materials or price increases or inventory adjustments), the change in the relationship shall be disclosed."

Oxford argues that the prescription data constitutes a known trend that Niaspan was "not selling or being prescribed" and that, therefore, Item 303(a)(3)(ii) requires its disclosure. There are, at least, two independently sufficient reasons why this contention cannot be sustained.

The first element of the Item 303 disclosure test set forth in Securities Act Release 6835 requires management to assess whether the "known trend, demand, commitment, event or uncertainty [is] likely to come to fruition." *Securities Act Release No. 33-6835*, 1989 WL 192885 at *6 (S.E.C.). As regards trends, we interpret this element to require an assessment of whether an observed pattern accurately reflects persistent conditions of the particular registrant's business environment. It may be that a particular pattern is, for example, of such short duration that it will not support any conclusions about the registrant's business environment. Release 6835 states that management's assessment "must be objectively

reasonable, viewed as of the time the determination is made." *Id.* We interpret this language as establishing a negligence standard.

Oxford's complaint says nothing about Item 303. Moreover, it does not allege facts that, if true, would support a finding of negligence as to Kos management's belief that the prescription data did not reflect that the uncertainties identified in the prospectus had been resolved against the marketability of Niaspan. This deficiency is highlighted by Uhl's discussion of Kos management's disagreement with his new projection, in which he specifically notes the experience and competence of Kos's management team and mentions several steps that could be taken to "help bolster awareness of the product." Uhl concludes with a significant admission: "Niaspan could be the first product of which we know where initial weekly prescriptions are not indicative of the product's ultimate success." The complaint alleges that management's assessment was incorrect and repeatedly emphasizes that, as to the issuer, Section 11 imposes strict liability for material omissions. However, in determining the existence of an omission based on Item 303's disclosure requirements, Release 6835 clearly established a negligence standard. Oxford's failure to allege facts from which the objective unreasonableness

of Kos management's decision not to include the prescription information in the prospectus could be inferred forecloses reliance upon Item 303 as a source of a duty to disclose that information.

A second, even clearer, barrier to Oxford's reliance upon Item 303(a)(3)(ii) is that it is primarily concerned with developments that render the registrant's reported results less indicative of the registrant's future prospects, a concern not implicated here. Instruction 3 to paragraph (a) provides:

> "3. The discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition. This would include descriptions and amounts of (A) matters that would have an impact on future operations and have not had an impact in the past, and (B) matters that have had an impact on reported operations and are not expected to have an impact upon future operations."

Item 303(a)(3)(ii) essentially says to a registrant: If there has been an important change in your company's business or environment that significantly or materially decreases the predictive value of your

reported results, explain this change in the prospectus. The obvious focus is on preventing the latest reported results from misleading potential investors, thereby promoting a more accurate picture of the registrant's future prospects.

Here, the prescription data was used by a market analyst to make a projection. This projection disappointed the market, which had been very optimistic about Kos because of the market analyst's prior, more favorable projection. However, the market's disappointment in the changed revenue projection did not render Kos's previously reported results unreliable. See *Glassman v. Computervision*, 90 F.3d 617, 632 (1st Cir. 1996). The prospectus stated that Kos had lost almost $80 million since its inception and that there could be no assurance that the company would ever be profitable. If booming Niaspan sales had carried Kos for the previous several reported quarters but suddenly and significantly declined, a potential investor could be mislead by those reported results unless Kos disclosed the importance of Niaspan and discussed the downward trend in Niaspan sales. That is the type of situation Item 303(a)(3)(ii) was designed to address. But that is not this case. Because the prescription information did not render Kos's reported results any materially less indicative of the company's

future prospects, Item 303(a)(3)(ii) does not require its disclosure.[4]

(c.) Misleading Prospectus

Oxford also argues that Kos had a duty to include the prescription data because the prospectus was materially misleading without it. We conclude that the prospectus thoroughly explained the risks involved in marketing Niaspan, and specifically warned that Niaspan might have a slow start. The Uhl report mentioned the possibility that Niaspan's first eight weeks may not be indicative of its ultimate market success. In view of all of this, the six weeks of prescription data, which represents only a very preliminary indication that Niaspan was staring slowly, did not have to be included in the prospectus. Such indication did not render materially misleading the

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[4] We need not address whether Item 303(a)(3)(ii) required Kos to discuss Niaspan's market acceptance as an uncertainty. Kos clearly did so, and the thrust of Oxford's complaint is that Kos's treatment of Niaspan's future as an uncertainty was misleading. We note, however, that Item 101 of Regulation S-K, 17 C.F.R. § 229.101, appears to require this kind of discussion. Item 101 requires a description of the registrant's business, including a discussion of the registrant's products. Item 101(c)(1)(ii) requires a narrative description of the status of products being developed and new products.

prospectus's treatment of the market acceptance of Niaspan as an uncertainty.

In sum, we hold that Kos had no duty to disclose the referenced prescription data in the prospectus.

B. Misrepresentation of Niaspan's Efficacy

The prospectus stated that Niaspan could increase HDL cholesterol by 22% to 32%. Paragraph 47 of the complaint alleges that Niaspan cannot increase HDL cholesterol by up to 32%. The only facts pleaded in support of this bald assertion were the results of two of the four clinical studies relied upon by Kos in stating the 22% to 32% range. These two studies showed that Niaspan could increase HDL by 23% and 26%. Kos claims that one of the four studies shows Niaspan can increase HDL by 32%. A study noting such results is referred to in Niaspan's package insert. At oral argument before this Court, Oxford complained that it had never seen this study and reiterated its view that the 32% claim was false.

The fatal flaw in Oxford's position is the complaint's failure to allege facts that support the conclusion that the 32% claim is false. As mentioned, the complaint only references two studies, both of which are consistent with the 22% to 32% range set forth in the prospectus. The district court held that

because both numbers from these sources were in the range quoted in the prospectus, neither was evidence that this range was false. We agree. No two clinical trials will produce exactly the same results. Cherry-picking two studies that show average HDL improvement of less than 32%, even significantly less, does not tend to establish that the stated range is false.

C. Misrepresentation of Niaspan's Safety

The prospectus stated that only about 1% of patients taking Niaspan experienced clinically significant increases in liver enzymes and that the threshold for clinical significance was three times the normal level.[5] Paragraph 51 of the complaint alleges that "Niaspan use elevated liver toxicity to an intolerable and unsafe level. By defining clinically significant elevations in liver function tests as 'greater than three times the upper limit of normal,' Kos misrepresented the industry standard as to what constitutes tolerable and safe levels of liver toxicity."

The complaint does not plead the existence of facts that would support its allegation that Niaspan

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[5] When liver cells are destroyed, certain enzymes that were contained within those cells spill into the bloodstream. Elevation of these enzymes indicates that liver cells are dying at an accelerated rate.

elevates liver enzymes to an intolerable level. The complaint fails to articulate what the proper threshold for clinical significance is, although, after the motions to dismiss were granted, Oxford asserted, in its response to the defendants' motions for sanctions, that it is twice the normal level. No studies are referred to, no specific facts are pleaded that indicate any basis for Oxford's bald assertions that Niaspan elevates liver enzymes to an intolerable level or that Kos employed the wrong standard in its clinical trials.

In its response to defendants' motions to dismiss, Oxford added an additional "safety" claim, which the district court, in the interest of fairness, considered. This claim was that the prospectus is misleading because it did not state that 88% of patients taking Niaspan would experience flushing. As regards the flushing issue, the prospectus stated: "Although most patients taking Niaspan will sometimes flush, the formulation and dosing regimen for Niaspan have been designed to maximize patient acceptance and minimize the occurrence of flushing. There can be no assurance, however, that patients using Niaspan will not suffer episodes of flushing that they consider intolerable." In view of this and other candid statements about the side effect of flushing that appear in the prospectus, we hold that the prospectus was not misleading in this respect.

D. Misrepresentations of Niaspan's Tolerability

Paragraph 63 of the complaint observes that subjects in Kos's clinical trials were given 2,000 mg of Niaspan per day and alleges that "only a tiny fraction of the market could tolerate such a high dose of Niaspan." The complaint alleges that the clinical studies were "rigged" because Kos "only administered high doses of Niaspan to subjects who were predetermined to have a high tolerance." The complaint does not even specify what side effect prevents all but a tiny fraction of the market from taking Niaspan. When, at oral argument, the district court asked for an explanation of the charge that the clinical trials the FDA based its approval on were "rigged", Oxford's response was that there must be some reason "why physicians don't prescribe it." We agree with the district court that the complaint fails to plead any factual basis for the charges found in paragraph 63.

E. Misrepresentation of $1.5 Million in September 1997 Sales

The prospectus estimated that Kos reaped $1.5 million in revenue from the sale of Niaspan during the quarter ending September 30, 1997. On November 12, 1997, Kos filed its 10Q for that quarter, which, consistent with the prospectus's estimate, stated that Kos had realized initial product sales of Niaspan in the

amount of $1.5 million. Paragraph 57 of the complaint alleges that the claim of $1.5 million in sales of Niaspan was false. The complaint does not allege any facts that support the conclusion that Kos had not sold $1.5 million in Niaspan by September 30, 1997, or that the $1.5 million figure was inaccurate in any respect. Paragraph 58 of the complaint alleges that, even if $1.5 million in sales did occur, such sales did not result from prescriptions, but rather from pipeline filling sales to wholesalers. The complaint alleges that Kos's statement, in the prospectus, that it "intends to market Niaspan directly to the specialist physicians within the cardiovascular market" somehow rendered the prospectus misleading without a statement clarifying that the $1.5 million in sales was to wholesalers.

The prospectus stated that Kos's sales force was providing "as a promotion item" three-week starter packs of Niaspan to physicians, which "generally are dispensed without a prescription", and that sales to warehouses commenced before the sales force began to market Niaspan to physicians. It is common knowledge in the pharmaceutical industry that "direct marketing" to physicians entails promoting the drug product to physicians and encouraging them to prescribe it for their patients. The prospectus simply does not state or imply that the $1.5 million resulted from prescriptions

or direct sales of Niaspan to physicians. The prospectus also plainly stated that Kos was selling Niaspan to wholesalers. The complaint has failed to plead facts that, if true, would constitute a misrepresentation of sales revenue, and does nothing more than offer the legal conclusion that the representation in the prospectus was somehow misleading.

We hold that the dismissal of Oxford's federal claims, with prejudice, was entirely proper.

IV. ATTORNEYS' FEE AWARD

15 U.S.C. §§ 77z-1(c) and 78u-4(c) require the district court, upon final adjudication of claims brought under the 1933 and 1934 Acts, respectively, to include specific findings as to each party's and each attorney's compliance with Fed. R. Civ. P. 11(b). These subsections also provide for a presumption that the proper sanction for a Rule 11(b) violation is an award, to the opposing party, of the reasonable attorney's fees and costs incurred as a direct result of the violation.

The district court found that Oxford's legal arguments were not frivolous and that Oxford performed an adequate investigation before filing its complaint, but that after such investigation a reasonable attorney would have realized that there was no

evidentiary support for any of the allegations in the complaint and that such support was unlikely to be unearthed by further investigation or discovery. The district court concluded that the plaintiffs were deliberately indifferent to the lack of evidentiary support for the conclusory allegations in the complaint and that plaintiffs' claims were objectively frivolous under Fed. R. Civ. P. 11(b)(3). The district court awarded $335,686.55 in fees and expenses to the Kos defendants and $184,405.27 to the Underwriter defendants. The plaintiffs and their counsel were each responsible for half of the award, or $260,045.91.

"An appellate court reviews all aspects of the district court's Rule 11 determination for an abuse of discretion." *WorldWide Primates, Inc. v. McGreal, 87 F.3d 1252, 1254 (11th Cir. 1996).*

The district court concluded that plaintiffs' claim regarding the omission of the prescription data was "not well grounded in fact" because it was essentially an amended claim that was advanced for the first time at the dismissal hearing. In a footnote, the district court observed that: "Just because, 'in the interests of justice,' the Court decided to entertain this 'essentially amended claim' in ruling upon the motions to dismiss, does not mean that the Court has to read Plaintiffs' presentation at oral argument into the Complaint when judging

whether Plaintiffs' claims were well grounded in fact." It is true that the complaint's reference to the Uhl report is only in the context of showing that the $1.5 million in Niaspan sales that occurred in September 1997 did not result from prescriptions, and that the plaintiffs did not allege that the prescription data should have been included in the prospectus until the dismissal hearing. The district court appears to have concluded that it is proper to consider such a claim in a motion to dismiss, but then fail to consider the factual allegations advanced in support thereof when resolving a motion for sanctions. The district court certainly did not have to consider the claim in resolving the motions to dismiss. However, in finding that the thus amended claim was without evidentiary support simply because it was not advanced until the dismissal hearing (and without considering the factual allegations advanced in support of the claim at such hearing), the district court abused its discretion. We conclude that this claim had factual support. The claim fails because we reject Oxford's legal argument as to a registrant's duty to disclose the prescription data under Item 303(a)(3)(ii). This argument, though ultimately rejected, was not frivolous and was adequately supported by the pleaded facts concerning the data and its predictive value.

As to plaintiffs' other claims, we cannot say that the district court's findings as to their lack of evidentiary support represented an abuse of discretion. Therefore, the district court's finding that plaintiffs and their counsel violated Rule 11(b)(3) in advancing these other claims is affirmed.

As to the award itself, plaintiffs complain that: 1) the total number of hours billed by the defendants-1900-was not reasonable considering the claims were dismissed before any discovery took place; 2) some of the defendants' billing records are redacted, vague and do not specify exactly what work the attorney was performing; and 3) the defendants failed to provide hourly rates for a significant portion of the time billed, instead submitting a chart of their average hourly rates.

"The starting point in any determination for an objective estimate of the value of a lawyer's services is to multiply hours reasonably expended by a reasonable hourly rate." *Norman v. Housing Authority of the City of Montgomery,* 836 F.2d 1292, 1299 (11th Cir. 1988). Our precedent places the burden of documenting the appropriate hours and hourly rates on the fee applicant. *Id.* Oxford does not challenge the reasonableness of the hourly rates submitted by the defendants. As to the number of hours submitted, "fee counsel should have maintained records to show the

time spent on the different claims, and the general subject matter of the time expenditures ought to be set out with sufficient particularity so that the district court can assess the time claimed for each activity. A well prepared fee petition also would include a summary, grouping the time entries by the nature of the activity or the stage of the case."[6] *Id.* at 1303 (citation omitted).

Under this standard, both of the fee applications presented to the district court were likely inadequate. Both contain several time entries that are so redacted that it is impossible to tell (beyond "research") what the attorney was doing. Most of the entries contain some description of the work performed, but there is very little information as to which claim the work pertained to. Thus, the district court could not have determined how many hours were spent defending each claim or accomplishing any particular task. Therefore, it could not have assessed whether any hours should be excluded (as redundant or unnecessary) or the hourly rate reduced (because the number of hours submitted for a particular activity was excessive). *Id.* at 1301, 1305-06.

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[6] We view a summary as desirable, but not necessary. We read "activity" as referring to a particular task, such as drafting a motion to dismiss.

Notwithstanding these difficulties, a district court faced with an inadequate fee application must still award a reasonable fee. *Id.* at 1303. Because courts are considered experts in this area, it is usually proper for the district court to award reasonable fees without an evidentiary hearing or additional pleadings. *Id.* Although the district court enjoys wide discretion in determining a reasonable fee, "the court's order on attorney's fees must allow meaningful review-the district court must articulate the decisions it made, give principled reasons for those decisions, and show its calculation." *Id.* at 1304.

Here, the district court found the total number of hours submitted by the defendants to be reasonable. The only explanation for this was that the "factual and legal complexities of this case" rendered "unpersuasive" plaintiffs' argument that the number of hours submitted was excessive. It is true that "sworn testimony that, in fact, it took the time claimed is evidence of considerable weight on the issue of the time required in the usual case and therefore [to justify a reduction of the hourly rate], it must appear that the time claimed is obviously and convincingly excessive under the circumstances." *Perkins v. Mobile Housing Board,* 847 F.2d 735, 738 (11th Cir. 1988).However, in *ACLU v. Barnes,* 168 F.3d 423, 430 (11th Cir. 1999), we

clarified *Perkins*: "Giving weight to sworn statements of fee applicants does not mean accepting those statements as gospel. Courts should not delegate their duty to examine and judge the reasonableness of fee applications to the applicants." Among other things, this means that in order to satisfy Norman's "meaningful review" requirement, the district court must respond to specific objections to a fee application with more than conclusory statements of reasonableness. *Id.* at 428.

We conclude that the district court did not abuse its discretion in refusing to reduce the hourly rate. It is true that the only explanation proffered by the district court-the factual and legal complexity of the case-is less than compelling. However, Oxford's objection to the total number of hours submitted was not specific. Barnes rested, in part, on the principle that "the more specific the objections to a fee application are, the more specific the findings and reasons for rejecting those objections can be." *Id.* at 428-29. Oxford did not propose what number of hours would have been reasonable, and therefore could not recommend any particular adjustment to the hourly rate. Oxford simply asserted, in the most general manner, that defense counsel took too many hours getting the case dismissed. Such a

boilerplate objection merits no more of a boilerplate response than that given.

Second, Oxford complains that the redacted time entries made it impossible for it to determine whether any of the work performed by defense counsel was redundant or unnecessary. While some entries were severely redacted, most were not. The district court concluded that surrounding time entries "demonstrate that the time claimed in these entries was spent on this matter, either performing legal research or discussing the case with unidentified individuals." This finding was not an abuse of discretion. The district court did not address the issue of redundance, but we think that where, as here, there is no indication that fee counsel has failed to exercise billing judgment, the total amount of time spent on "research" is reasonable, and the number of entries that fail to contain details about what research is being performed is relatively small, it is within the district court's discretion to include those hours in the award. We caution, however, that where a significant number of entries are severely redacted or it appears that fee counsel has failed to use billing judgment, it may be an abuse of discretion to award fees based on the redacted entries.

Finally, Oxford complains that Kos's counsel has only submitted a chart of average hourly rates for a

significant part of the time billed. Oxford advanced this argument before the district court. In response, Kos pointed out that the actual hourly billing rates (along with an unredacted version of most of the time entries) was contained in Exhibit F of the record. That is indeed the case.

Oxford's other contentions regarding the award are so devoid of merit that it was not an abuse of discretion for the district court to fail to address them.

The only issue requiring remand is the proper apportionment of the award. The district court recognized that opposing parties are only entitled to attorney's fees and costs associated with defending frivolous claims. *Simon DeBartolo Group, L.P. v. Richard E. Jacobs Group, Inc.*, 186 F.3d 157, 166-67, 177 (2nd Cir. 1999). Accordingly, Defense counsel are entitled to fees and expenses incurred in defending against all claims except the claim that Kos should have included the partial, preliminary prescription sales data in the prospectus. We realize that because this claim was not advanced until oral argument at the hearing to dismiss, the amount of fees and expenses incurred in defending against it is probably small. Nevertheless, the law requires that the award not include such fees and expenses. The district court has wide latitude in determining how to apportion the award, but it must

explain its decision such that it is capable of meaningful review.

CONCLUSION

For the reasons stated, the district court's dismissal of Oxford's federal claims, with prejudice, is affirmed. It follows that the district court's dismissal of Oxford's state and common law claims must also be affirmed.

The district court's finding that the plaintiffs and their counsel violated Rule 11(b)(3) by being deliberately indifferent to the lack of factual support for the claims asserted in the complaint is affirmed, except as to the amended claim concerning the omission of the preliminary prescription sales data, which is reversed. The district court's award of fees and expenses is vacated and remanded so that the district court can properly apportion the award, i.e. exclude fees and expenses incurred in defending against the lone non-frivolous claim.

In No. 00-11690, the judgment is AFFIRMED;

In No. 00-13220, the judgment is VACATED and the matter is REMANDED for further proceedings consistent herewith.

Appendix J

Complaint

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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MORDECHAI GURARY,

Plaintiff,

-against-

ISAAC WINEHOUSE, ISAAC WINEHOUSE d/b/a WALL & BROAD EQUITIES and NU-TECH BIO-MED, INC.,

Defendants.

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97 Civ. 3803

COMPLAINT

Jury Trial Demanded

Plaintiff, by his attorneys, **JAROSLAWICZ & JAROS**, complaining of the defendants, alleges as follows:

THE PARTIES

1. At all times hereinafter mentioned, plaintiff, Mordechai Gurary, is a citizen of the State of New York.

2. At all times hereinafter mentioned, the defendant, Isaac Winehouse ("Winehouse"), is believed to be a resident of the State of New York and citizen of Israel.

3. At all times hereinafter mentioned, the defendant Winehouse is doing business under the name of Wall & Broad Equities, among entities that he controls.

4. At all times hereinafter mentioned, the defendant, Nu-Tech Bio-Med, Inc. ("Nu-Tech"), is a Delaware corporation with its principal place of business in the State of New York.

JURISDICTION & VENUE

5. This Court has jurisdiction over this matter pursuant to the Securities Exchange Act of 1934, 15 U.S.C. 78aa, since the claims herein arose under Section 10(b) of the Securities Exchange Act of 1934.

6. Venue is proper in this District pursuant to Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. 78aa since the corporation is located here and most of the acts complained of occurred within this District.

7. Many of the acts complained of herein, including the dissemination of information, the agreement entered into with respect to the December 1996 placement, commonly known as a Regulation D Placement, for a total purchase price of $14 million, and the manipulation of the stock price of Nu-Tech, took place within this District.

8. In connection with the acts alleged in this complaint, the defendant Winehouse and others included in his cartel, directly and indirectly, used the means and instrumentalities of interstate commerce, including the mails, telephone communications, and the facilities of national security exchanges, to perpetrate their fraud.

THE UNDERLYING FACTS

9. That Nu-Tech was originally organized in approximately 1981.

10. That Nu-Tech is traded on the NASDAQ stock market under the symbol NTBM.

11. That the price of Nu-Tech stock hit a high of approximately $16 per share in November 1996.

12. That the price of Nu-Tech stock was relatively stable between October and November 1996.

13. That the plaintiff made at least the following purchases of Nu-Tech stock:

AMOUNT OF SHARES	PRICE PER SHARE	DATE OF PURCHASE
1,000	$14.60	1/31/96
5,500	15 1/2	11/7/96
1,000	11 3/4	12/24/96
8,350	11 19/16	2/18/97

14. That by early March 1997, due to the prior actions and continuing improper manipulations of the defendant Winehouse and others, Nu-Tech stock dropped precipitously so that it is trading in the area of $2 per share.

15. That the defendant Winehouse was the organizer and/or one of the key people of a cartel organized to engage in transactions in the purchase of the Regulation D Placement and the sale of Nu-Tech stock and perhaps other securities.

16. That this group arranged to participate in a purchase, under circumstances not totally known to the plaintiff, of a percentage of the 14 million dollars' worth of Nu-Tech stock, to wit, some fourteen thousand shares of Series A Convertible Preferred Stock for a total aggregate price of $14 Million, and upon information and belief this took place in approximately November 1996.

17. That during this time period, the defendant Winehouse arranged for certain market makers to become market makers in Nu-Tech stock; these market makers included Alexander Securities and Sun Coast Securities, and perhaps others; that in addition to this, it is believed that at this time there are approximately sixteen market makers in the stock of Nu-Tech, to wit the firms of Wien Securities; Knight Securities; Kensington Capital; Paragon Capital Corp.; Southwest Securities; Spencer Edwards; Hill Thompson Magid; Meyer & Schweitzer; Sharp Capital; Duke & Co.; Nash Weiss & Co.; D. Weckstein & Co.; Starr Securities; Wall Street Equities; Herzog Heine Geduld; and Grunthal.

18. Upon information and belief, the defendant Winehouse arranged for, or was instrumental in having one or more of these market makers become a market maker in Nu-Tech in order for

them to be used in his scheme of manipulating the price of and permitting him to engage in short-selling Nu-Tech stock.

19. That the Series A Convertible Preferred Stock obtained by Winehouse through nominees and other members of his cartel whose names are not yet known to plaintiff, is convertible into shares of common stock of Nu-Tech at either (a) $17.50 per share; or (b) seventy-five (75%) percent of the average closing price of the company's common stock as represented by NASDAQ for the five trading days prior to the date of the holder's note of conversion.

20. That the Series A Convertible Preferred Stock is converted into the company's common stock at the option of the holder commencing on the forty-fifth day after the issue date with one-third of the shares being permitted to be converted into common stock on the forty-fifth, seventy-fifth and one hundred-fifth days after the issue date.

21. That the initial issue date was November 6, 1996 and the first day upon which the holders could initially obtain a conversation of Series A Convertible Preferred Stock was December 20, 1996.

22. That commencing on the two hundred-seventieth day following the completion of the private

placing, Nu-Tech had the right, on thirty days prior notice, to compel Series A Preferred Stock to be converted into common stock at the then applicable conversion price.

AS AND FOR A FIRST CLAIM FOR RELIEF AS AGAINST THE DEFENDANTS ISAAC WINEHOUSE AND ISAAC WINEHOUSE D/B/A WALL & BROAD EQUITIES

23. That Winehouse and other members of his cartel reached a secret arrangement whereby a large part of the $14 million purchase of Series A Preferred Convertible Stock was purchased in the name of other nominees who were not really the owners of the stock, and who later engaged in short-selling Nu-Tech stock in the name of other nominees.

24. That following the acquisition of a large part of the fourteen thousand shares of Series A Convertible Preferred Stock, Winehouse and his group manipulated the price of Nu-Tech stock.

25. It is also improper under the regulations of the Securities & Exchange Commission ("SEC") and the stock exchange for someone who purchases a convertible preferred stock to short stock and to do so under different names in order to conceal the identity

of the person shorting and the fact that the same people who have a beneficial right to purchase or convert preferred stock into common stock are engaged in shorting the stock.

26. That the defendant Winehouse and other members of his cartel, whose names have not yet been established, engaged in a series of efforts to conceal that they were shorting Nu-Tech

stock, using various nominee accounts which they had set up, with the ultimate beneficiaries being Winehouse, Wall & Broad Equities and members of Winehouse's cartel.

27. That the activities of Winehouse and the members of his group became known to Nu-Tech and its Chairman, one Marvin Feigenbaum.

28. That in or about December 1996, Mr. Feigenbaum, the Chairman of Nu-Tech called Winehouse and Winehouse's counsel to advise that if the Winehouse group did not stop shorting Nu-Tech stock, he would not permit the registration of the convertible shares to become effective.

29. Upon information and belief, a meeting was held on February 18, 1997 at Nu-Tech's offices at 500 Fifth Avenue in New York City, which meeting was attended by Winehouse, Abe Silver, Sam Popack, Mr.

Hagar, Stuart Kahan, Marvin Feigenbaum and others. At which time, Feigenbaum, on behalf of the company, requested Winehouse and his cartel and group to stop shorting Nu-Tech stock and offered that within six months Nu-Tech would repurchase their convertible preferred stock for the $14 million which had been originally paid plus ten percent interest on the $14 million and that the short sellers would be permitted to keep their profits.

30. That to the knowledge of plaintiff, no agreement was reached at that meeting with Winehouse and his cartel demanding still more benefits from the company.

31. That the fact that this meeting took place as well as the offer made by the company to Winehouse was concealed from the investing public.

32. Upon information and belief, on or about March 12, 1997 a second meeting took place at the offices of Fagenson & Co., 19 Rector Street in New York City, which meeting was attended by Robert Fagenson, a member of the Board of Directors of Nu-Tech; Silver; Popack; Winehouse and others; and Marvin Feigenbaum, Chairman of Nu-Tech.

33. Upon information and belief, at that meeting Nu-Tech sought to have the defendant

Winehouse and his group agree that their stock would be registered over a twelve-month period.

34. Upon information and belief, that Winehouse indicated this was not satisfactory and stated he would continue his short-selling activities.

35. That the following day Nu-Tech stock dropped approximately $3 and the day thereafter an additional $3. Upon information and belief, this was caused in large part by short selling by Winehouse and his group.

36. That on or about March 14, 1997, Nu-Tech issued a press release which was flagrantly misleading, indicating that it believed the decline in the price of Nu-Tech stock could be attributable to "possible sales by shareholders" (Exhibit A).

37. That Nu-Tech concealed the various meetings and what had transpired, and their knowledge as to the Winehouse group shorting Nu-Tech stock.

38. In the interim, Winehouse, through his counsel Heller, Horowitz & Feit, P.C., was negotiating with counsel for Nu-Tech, all of which information was not made publicly available.

39. That the activities of Winehouse and his cartel, and the various names Winehouse and his group

have been doing business under, to purchase the convertible stock and then shorting the Nu-Tech stock and manipulating its price, constituted a fraud upon the market.

40. In addition, the defendant Winehouse and the other members of his cartel engaged in a planned scheme and course of conduct pursuant to which they knowingly sought to manipulate the price of Nu-Tech stock by improperly shorting the stock under different names to conceal their true identities.

41. That the defendants made numerous misstatements of material fact and omitted to state material facts necessary in order to make statements not misleading in light of the circumstances under which they were made.

42. As a result of these defendants' fraudulent conduct, plaintiff were caused to purchase Nu-Tech's stock at artificial prices and to incur substantial losses.

43. That the defendants' conduct constituted a deliberate violation of §10b of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.

44. By reason of the foregoing, the defendants are jointly and severally liable to the plaintiff.

45. By reason of the foregoing, plaintiff is entitled to recover all of his damages from these defendants.

AS AND FOR A SECOND CLAIM FOR RELIEFAS AGAINST THE DEFENDANT NU-TECH BIO-MED, INC.

46. Plaintiff hereby repeats, reiterates and realleges each and every allegation contained in paragraphs of this complaint numbered "1" through "45" inclusive, with the same force and effect as if more fully set forth at length herein.

47. That the defendant Nu-Tech failed to reveal the sale to Winehouse and his group through the use of nominees; that there were meetings going on between Winehouse and his group and Nu-Tech; that Nu-Tech was aware of the short-selling by Winehouse and his group; that Nu-Tech would refuse to register certain stocks due to the short-selling activities of Winehouse and his group; that, in fact, when Nu-Tech finally did issue a public statement in response to an inquiry from the NASDAQ, it issued a deliberately misleading statement as to the reason for the stock's decline (Exhibit A), omitting to state the real reason and

that negotiations were taking place between Nu-Tech and the Winehouse group.

48. That during this same period, Nu-Tech was engaging in an attempt to acquire certain debt securities of Physicians Clinical Laboratory, Inc. ("PCL"); that the PCL deal was subject to the approval of the United States Bankruptcy Court for the Central District of California, case number SV 96-23185-GM; that in order to conceal from the Bankruptcy Court, the market and plaintiff as to what was taking place and in an attempt to induce Winehouse and other short sellers not to object to the plan in the Bankruptcy Court, Nu-Tech concealed this critical information from the public and from the plaintiff.

49. That Nu-Tech's conduct constituted fraud with respect to concealing material information and providing misinformation pursuant to 15 U.S.C. 78(j) and Rule 10 b-5 promulgated thereunder.

50. By reason of the foregoing, plaintiff has been damaged as aforesa*id.*

51. By reason of the foregoing, the defendants are jointly and severally liable to the plaintiff.

52. By reason of the foregoing, plaintiff is entitled to recover all of his damages from this defendant.

AS AND FOR A THIRD CLAIM FOR RELIEF AS AGAINST ALL THE DEFENDANTS

53. Plaintiff hereby repeats, reiterates and realleges each and every allegation contained in paragraphs of this complaint numbered "1" through "45" and "47" through "52" inclusive, with the same force and effect as if more fully set forth at length herein.

54. That the conduct of Winehouse and his group and Nu-Tech constituted a fraudulent business practice in direct violation of §349 of the General Business Law of the State of New York.

55. By reason of the foregoing, plaintiff has been damaged as aforesa*id.*

56. By reason of the foregoing, the defendants are jointly and severally liable to the plaintiff.

57. By reason of the foregoing, plaintiff is entitled to recover all of his damages from the defendants, including treble damages, punitive damages and attorneys' fees.

AS AND FOR A FOURTH CLAIM FOR RELIEF AS AGAINST THE DEFENDANT NU-TECH BIO-MED, INC.

58. Plaintiff hereby repeats, reiterates and realleges each and every allegation contained in paragraphs of this complaint numbered "1" through "45", "47" through "52" and "54" through "57" inclusive, with the same force and effect as if more fully set forth at length herein.

59. That the plaintiff does not have a complete or adequate remedy at law.

60. That Nu-Tech should be enjoined from registering the $14 million Series A Convertible Preferred Stock pending the hearing and determination of this action.

WHEREFORE, plaintiff demands judgment as against the defendants, both jointly and severally, as follows:

(a) Awarding plaintiff all compensatory damages such as may be permitted, together with interest;

(b) Enjoining Nu-Tech from registering the $14 million Series A Convertible Preferred Stock pending the hearing and determination of this action;

(c) Awarding plaintiff costs and expenses incurred, including reasonable attorneys' fees, expert fees, as well as treble damages and punitive damages; and

(d) Awarding plaintiff such other and further relief as to this Court may seem just and proper.

Dated: New York, New York
May 15, 1997

JAROSLAWICZ & JAROS, ESQS.
Attorneys for Plaintiff(s)

By: S/_____
David Jaroslawicz (DJ 6931)

Office and Post Office Address
150 William Street
New York, New York 10038
(212) 227-2780

Appendix K

Affidavit Of Plaintiff Gurary Dated August 20, 1997 Submitted In Opposition To Defendants' Rule 12(b)(6) Motion

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

----------X

MORDECHAI GURARY, 97 Civ. 3803

Plaintiff,

-against-

AFFIDAVIT IN OPPOSITION

ISAAC WINEHOUSE, ISAAC WINEHOUSE d/b/a WALL & BROAD EQUITIES and NU-TECH BIO-MED, INC.,

Defendants.

----------X

STATE OF NEW YORK }
} ss.:
COUNTY OF NEW YORK }

MORDECHAI GURARY, being duly sworn, deposes and says:

I am currently the holder of 36,400 shares in Nu-Tech Bio Med, Inc. ("Nu-Tech") and am making this affidavit with respect to the defendants" motions to dismiss.

The facts of this case are that I, and numerous other innocent investors, invested substantial funds in Nu-Tech when the stock was trading between approximately eleven dollars a share and fifteen dollars a share.

That in about November, 1996, the company, in an effort to raise money, entered into an arrangement, which I am advised is known as a Regulation D Placement, where they raised fourteen million dollars from certain investors. These investors were entitled to a Series A Convertible Preferred Stock. These investors would be entitled to convert their shares into Nu-Tech common stock at either $17.50 per share or seventy-five (75%) percent of the average closing price of the company's common stock as reported by NASDAQ for the five trading days prior to the date the holder's note of conversion.

That this Series A Convertible Preferred Stock was convertible at the holder's opinion, commencing forty-five days after the issue date, with one-third of the shares being permitted to be converted into common

stock on day forty-five, one-third on day seventy-five and on-third on day one hundred-five after issue date.

That the initial issue date for the Series A Convertible Preferred Stock was November 6, 1996 with the anticipation that the first day upon which the holders could convert the Series A Convertible Preferred Stock would be December 20, 1996.

That Isaac Winehouse, whom I have met with and spoken to, has been involved, through an entity known as Wall & Broad Equities, and through various nominees, in buying and selling different securities.

As can be seen from Exhibit B to the motion papers by Nu-Tech (pp. 28-29), as well as Exhibit A to this affidavit, Mr. Winehouse's name appears nowhere in the prospectus as one of the owners of any of the Series A Convertible Preferred Stock.

Nevertheless, Mr. Winehouse, acting on behalf of unknown nominees, was the moving force behind the scheme which had been entered into by certain purchasers of the Series A Convertible Preferred Stock to, in essence, lock in a profit by shorting Nu-Tech stock, knowing that the lower the price of Nu-Tech stock, the greater would be their profit because the cheaper they would be able to buy it at seventy five

percent of whatever the average price was five trading days prior to their conversion.

That in an unusual move, when it became obvious to the company that certain Series A Convertible Preferred Stock holders were shorting the stock, the company, after filing with the SEC, withdrew its proposed registration of that stock in late December 1996.

When Nu-Tech stock started to decline, I, as other shareholders of Nu-Tech, became concerned. I personally spoke to Marvin Feigenbaum, the president of Nu-Tech, in or about December, 1996—I do not recall the exact date—and he advised me that he had spoken to Isaac Winehouse, the defendant in this case, as well as to Mr. Winehouse's counsel, Heller, Horowitz & Feit, P.C. and alerted them that if the Winehouse group did not stop shorting Nu-Tech stock, he would withdraw the registration of those shares so that the group, rather than being assured of a locked-in profit, would have to buy the stock in the open market at possibly higher prices and that this would convince them not to continue shorting the stock.

I continued to buy Nu-Tech stock, buying one thousand shares on December 24, 1996 at 11-3/4.

Thereafter, the Winehouse group continued to short the stock. I investigated into the matter and was advised that in order to short the stock, Winehouse had arranged for certain market makers, small brokerage firms, who were friendly to him, to become so-called market makers in Nu-Tech, thus permitting the defendants to short the stock, through those brokerage firms, without having the stock available. This way the Winehouse group could short an unlimited amount of stock.

I am advised that the brokerage firms involved in becoming market makers and assisting Mr. Winehouse included Alexander Securities, Sharp, Grunthal, and Sun Coast Securities.

I was advised by a broker in Canada who works for Gundy & Co. in Toronto, Canada, that Mr. Winehouse and his group were shorting substantial amounts of Nu-Tech stock through Gundy & Co. through various nominees. The names of those nominees are currently unknown to me but can be revealed during discovery if we are permitted to take the depositions of Alexander Securities, Sun Coast Securities, Gundy & Co., Sharp, Grunthal, and others, and, most importantly, Mr. Winehouse himself.

On or about February 18, 1997, I again spoke to Marvin Feigenbaum, president of Nu-Tech, who

advised me that a meeting had been held that day at Nu-Tech's offices at 500 Fifth Avenue, New York, New York. According to Mr. Feigenbaum, that meeting was attended by the defendant Winehouse, and other gentlemen, including, Abe Silver, Sam Popack, Mr. Hagar, Stuart Kahan, and others.

At the meeting on February 18,1997, Mr. Feigenbaum had requested Mr. Winehouse and his group, which members Mr. Winehouse refused to identify, to stop shorting Nu-Tech stock. According to Mr. Feigenbaum, in order to stop the shorting of Nu-Tech stock, he offered Mr. Winehouse and his group to repurchase all Series A Convertible Preferred Stock for the fourteen million dollars which had been paid plus ten percent interest, and the short-sellers would be permitted to keep the profit they had made to date.

Mr. Feigenbaum advised me that he had told Mr. Winehouse and the other persons who were Series A Convertible Preferred shareholders at the meeting that Nu-Tech was due to receive the Bankruptcy Court's approval on April 18, 1997 to purchase Physicians Clinical Laboratory, Inc. ("PCL") in California and therefore he needed sixty days after the Bankruptcy Court approved the purchase of the laboratory on April 18, 1997, to raise the money to repay the Series A Convertible Preferred shareholders.

According to Mr. Feigenbaum, Mr. Winehouse refused to agree to this but instead advised Mr. Feigenbaum that it was not to Mr. Winehouse's personal benefit to resolve the dispute on those terms and he would see to it that Mr. Feigenbaum did not have a future in the company—because his options at $7 and $11.50 would be worthless, to which Mr. Feigenbaum responded that, if necessary he would get his option plan reissued at $1. Mr. Winehouse also said he would see to it that the price of Nu-Tech stock would fall significantly.

Mr. Feigenbaum further advised me that the Board of Directors had designated Robert Fagenson and one other Board member to negotiate with Mr. Winehouse and the Reg. D holders.

Mr. Feigenbaum further advised me that the company would not give in to Mr. Winehouse's blackmail and would refuse to register the short-sellers" shares.

I then purchased another 8,350 shares of Nu-Tech stock on February 18, 1997 at 11-9/16.

I was later advised by Mr. Feigenbaum that another meeting had taken place on March 12, 1997 at the offices of Fagenson and Company, 19 Rector Street, New York, New York, and attending the meeting were

Robert Fagenson, who is a member of the Board of Nu-Tech; Abe Silver; Mr. Popack; the defendant Winehouse; and Mr. Feigenbaum.

According to Mr. Feigenbaum, during this meeting, Mr. Fagenson asked Mr. Winehouse, who are you, your name does not appear in the list of the Reg. D. investors. Mr. Winehouse responded that he represented "some people", but refused to identify them. Mr. Fagenson, on behalf of Nu-Tech, sought to have Mr. Winehouse agree that he and his group would stipulate that their stock would be registered over a twelve-month period rather than immediately. Mr. Feigenbaum advised me that Mr. Winehouse refused to agree to this and stated he would continue to his short-selling activities and would drive the stock down until there was nothing left of Nu-Tech.

According to Mr. Feigenbaum, Mr. Winehouse also stated he would have an adverse article placed in Crane's Magazine which would adversely affect Nu-Tech stock, to which Mr. Fagenson replied he personally did not care what Mr. Winehouse because he only owned twelve thousand shares of Nu-Tech stock.

The very next day, March 13, 1997, the price of Nu-Tech stock dropped approximately three dollars and the day after that an additional three dollars.

Apparently, Mr. Winehouse was making good on his threat to drive down the price of Nu-Tech.

Despite knowing all of this, the company said nothing about the meetings with Mr. Winehouse, the short-selling activities of the Series A Convertible Preferred Stock holders, until March 14, 1997 when the company issued a misleading press release stating that the company believed that the price decline of the stock could be attributed to "possible sales by shareholders" (Exhibit C).

This was obviously totally misleading. All the time Mr. Winehouse, whose name does not appear anywhere in the registration statement, was negotiating with Mr. Fagenson, a member of the Board of Nu-Tech, and Mr. Feigenbaum, its chairman. There were also communications between Mr. Winehouse's counsel and Nu-Tech's counsel; see for example, Exhibit B dated March 25, 1997, which communication fully supports what I had been told by Mr. Feigenbaum.

On March 18, 1997, I was contacted by Howard Weiss of Los Angeles, California, who is personally known to me and was also apparently friendly with Mr. Winehouse. Mr. Weiss advised me that he had Mr. Winehouse on the telephone as part of a conference call. Mr. Winehouse then stated he had heard I was upset with respect to what was taking place regarding his

activities in Nu-Tech and wanted to know why I was upset.

I explained to Mr. Winehouse that his activities had caused the value of Nu-Tech stock to drop drastically and many innocent shareholders, such as myself and others who had purchased Nu-Tech stock, had been injured.

During this telephone conversation, Mr. Winehouse personally admitted to me, while Mr. Weiss was on the telephone, that he had arranged for four market makers, Sharp, Alexander Securities, Sun Coast Securities and Grunthal, to become market makers in Nu-Tech stock to enable Mr. Winehouse and his group to short unlimited amounts of Nu-Tech stock.

During this same conversation, Mr. Winehouse requested me to "calm down" and agreed to meet with me.

I then met with Mr. Winehouse at 9:00 a.m. the following morning, which I believe was March 19, 1997, at his offices under the name of Wall & Broad Equities. During this meeting, Mr. Winehouse admitted that he had manipulated the price of Nu-Tech stock and deliberately sought to short the stock to drive the price of the stock down; that he was going to continue to do so and advised me to get out and sell my Nu-Tech stock

because the price of the stock was going to do down to "a dollar."

I advised Mr. Winehouse that there would be substantial losses to myself and other shareholders and that he should please cease his activities with respect to Nu-Tech stock.

Mr. Winehouse informed me that he could not cease his activities and that he could not worry about the other shareholders, but with respect to myself he would see to it that I was compensated for my losses.

Needless to say, I refused Mr. Winehouse's offer.

The reason Nu-Tech had a motive to conceal what was taking place between December 1996 and April 1997 was that in the interim, Nu-Tech was trying to buy another company known as Physicians Clinical Laboratory, Inc. ("PCL"), which company was in bankruptcy in the United States Bankruptcy Court for the Central District of California, case number CV-96-23185-GM.

That this purchase was troubling Nu-Tech is demonstrated in the March 25, 1997 letter from Mr. Winehouse's counsel (Exhibit B), specifically referring to no sales of stock taking place prior to the bankruptcy order in the PCL case becoming effective, and that there was an objection filed by the SEC in Bankruptcy Court

with respect to the reorganization plan prepared by PCL and Nu-Tech (Exhibit B). Nu-Tech wanted nothing to occur which could interfere with its purchase of PCL in the Bankruptcy Court in California which was scheduled for April 18, 1997.

In short, Mr. Winehouse and his group were manipulating Nu-Tech stock by having small brokerage firms become market makers in the stock so that they could short the stock without having available stock; Mr. Winehouse and his group were shorting the stock and manipulating the market prices for the stock while I, and other innocent investors, purchased Nu-Tech stock during the period November 7, 1996 to April 1, 1997, and Nu-Tech concealed what was going on because it was engaged in attempting to acquire PCL and if this information got out about its dispute with preferred shareholders who, in essence, could control the company, it could affect Nu-Tech's ability to buy PCL in the Bankruptcy Court.

I believe I have a valid claim against all the defendants in this case and the motions to dismiss should be denied in all respects.

S/_____

MORDECHAI GURARY

Sworn to before me this

20th day of August, 1997

S/_____

Notary Public

Appendix L

Statute Involved, Private Securities Litigation Reform Act § 15 U.S.C. § 78u-4

UNITED STATES CODE SERVICE

TITLE 15. COMMERCE AND TRADE

CHAPTER 2B. SECURITIES EXCHANGES

§ 78u-4. Private securities litigation

(a) Private class actions.

(1) In general. The provisions of this subsection shall apply in each private action arising under this title [*15 USCS §§ 78a* et seq.] that is brought as a plaintiff class action pursuant to the Federal Rules of Civil Procedure.

(2) Certification filed with complaint.

(A) In general. Each plaintiff seeking to serve as a representative party on behalf of a class shall provide a sworn certification, which shall be personally signed by such plaintiff and filed with the complaint, that—

(i) states that the plaintiff has reviewed the complaint and authorized its filing;

(ii) states that the plaintiff did not purchase the security that is the subject of the complaint at the direction of plaintiff's counsel or in order to participate in any private action arising under this title [*15 USCS §§ 78a* et seq.];

(iii) states that the plaintiff is willing to serve as a representative party on behalf of a class, including providing testimony at deposition and trial, if necessary;

(iv) sets forth all of the transactions of the plaintiff in the security that is the subject of the complaint during the class period specified in the complaint;

(v) identifies any other action under this title [*15 USCS §§ 78a* et seq.], filed during the 3-year period preceding the date on which the certification is signed by the plaintiff, in which the plaintiff has sought to serve as a representative party on behalf of a class; and

(vi) states that the plaintiff will not accept any payment for serving as a representative party on behalf of a class

beyond the plaintiff's pro rata share of any recovery, except as ordered or approved by the court in accordance with paragraph (4).

(B) Nonwaiver of attorney-client privilege. The certification filed pursuant to subparagraph (A) shall not be construed to be a waiver of the attorney-client privilege.

(3) Appointment of lead plaintiff.

(A) Early notice to class members.

(i) In general. Not later than 20 days after the date on which the complaint is filed, the plaintiff or plaintiffs shall cause to be published, in a widely circulated national business-oriented publication or wire service, a notice advising members of the purported plaintiff class—

(I) of the pendency of the action, the claims asserted therein, and the purported class period; and

(II) that, not later than 60 days after the date on which the notice is published, any member of the purported class

may move the court to serve as lead plaintiff of the purported class.

(ii) Multiple actions. If more than one action on behalf of a class asserting substantially the same claim or claims arising under this title [*15 USCS §§ 78a* et seq.] is filed, only the plaintiff or plaintiffs in the first filed action shall be required to cause notice to be published in accordance with clause (i).

(iii) Additional notices may be required under Federal Rules. Notice required under clause (i)shall be in addition to any notice required pursuant to the Federal Rules of Civil Procedure.

(B) Appointment of lead plaintiff.

(i) In general. Not later than 90 days after the date on which a notice is published under subparagraph (A)(i), the court shall consider any motion made by a purported class member in response to the notice, including any motion by a class member who is not individually named as a plaintiff in the complaint or complaints,

and shall appoint as lead plaintiff the member or members of the purported plaintiff class that the court determines to be most capable of adequately representing the interests of class members (hereafter in this paragraph referred to as the "most adequate plaintiff") in accordance with this subparagraph.

(ii) Consolidated actions. If more than one action on behalf of a class asserting substantially the same claim or claims arising under this title [*15 USCS §§ 78a* et seq.] has been filed, and any party has sought to consolidate those actions for pretrial purposes or for trial, the court shall not make the determination required by clause (i) until after the decision on the motion to consolidate is rendered. As soon as practicable after such decision is rendered, the court shall appoint the most adequate plaintiff as lead plaintiff for the consolidated actions in accordance with this paragraph.

(iii) Rebuttable presumption.

(I) In general. Subject to subclause (II), for purposes of clause (i), the court shall adopt a presumption that the most adequate plaintiff in any private action arising under this title [*15 USCS §§ 78a* et seq.] is the person or group of persons that–

(aa) has either filed the complaint or made a motion in response to a notice under subparagraph (A)(i);

(bb) in the determination of the court, has the largest financial interest in the relief sought by the class; and

(cc) otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure.

(II) Rebuttal evidence. The presumption described in subclause (I) may be rebutted only upon proof by a member of the purported plaintiff

class that the presumptively most adequate plaintiff—

(aa) will not fairly and adequately protect the interests of the class; or

(bb) is subject to unique defenses that render such plaintiff incapable of adequately representing the class.

(iv) Discovery. For purposes of this subparagraph, discovery relating to whether a member or members of the purported plaintiff class is the most adequate plaintiff may be conducted by a plaintiff only if the plaintiff first demonstrates a reasonable basis for a finding that the presumptively most adequate plaintiff is incapable of adequately representing the class.

(v) Selection of lead counsel. The most adequate plaintiff shall, subject to the approval of the court, select and retain counsel to represent the class.

(vi) Restrictions on professional plaintiffs. Except as the court may otherwise permit, consistent with the purposes of

this section, a person may be a lead plaintiff, or an officer, director, or fiduciary of a lead plaintiff, in no more than 5 securities class actions brought as plaintiff class actions pursuant to the Federal Rules of Civil Procedure during any 3-year period.

(4) Recovery by plaintiffs. The share of any final judgment or of any settlement that is awarded to a representative party serving on behalf of a class shall be equal, on a per share basis, to the portion of the final judgment or settlement awarded to all other members of the class. Nothing in this paragraph shall be construed to limit the award of reasonable costs and expenses (including lost wages) directly relating to the representation of the class to any representative party serving on behalf of a class.

(5) Restrictions on settlements under seal. The terms and provisions of any settlement agreement of a class action shall not be filed under seal, except that on motion of any party to the settlement, the court may order filing under seal for those portions of a settlement agreement as to which good cause is shown for such filing under seal.

For purposes of this paragraph, good cause shall exist only if publication of a term or provision of a settlement agreement would cause direct and substantial harm to any party.

(6) Restrictions on payment of attorneys' fees and expenses. Total attorneys' fees and expenses awarded by the court to counsel for the plaintiff class shall not exceed a reasonable percentage of the amount of any damages and prejudgment interest actually paid to the class.

(7) Disclosure of settlement terms to class members. Any proposed or final settlement agreement that is published or otherwise disseminated to the class shall include each of the following statements, along with a cover page summarizing the information contained in such statements:

(A) Statement of plaintiff recovery. The amount of the settlement proposed to be distributed to the parties to the action, determined in the aggregate and on an average per share basis.

(B) Statement of potential outcome of case.

(i) Agreement on amount of damages. If the settling parties agree on the average

amount of damages per share that would be recoverable if the plaintiff prevailed on each claim alleged under this title [*15 USCS §§ 78a* et seq.], a statement concerning the average amount of such potential damages per share.

(ii) Disagreement on amount of damages. If the parties do not agree on the average amount of damages per share that would be recoverable if the plaintiff prevailed on each claim alleged under this title [*15 USCS §§ 78a* et seq.], a statement from each settling party concerning the issue or issues on which the parties disagree.

(iii) Inadmissibility for certain purposes. A statement made in accordance with clause (i) or (ii) concerning the amount of damages shall not be admissible in any Federal or State judicial action or administrative proceeding, other than an action or proceeding arising out of such statement.

(C) Statement of attorneys' fees or costs sought. If any of the settling parties or their counsel

intend to apply to the court for an award of attorneys' fees or costs from any fund established as part of the settlement, a statement indicating which parties or counsel intend to make such an application, the amount of fees and costs that will be sought (including the amount of such fees and costs determined on an average per share basis), and a brief explanation supporting the fees and costs sought. Such information shall be clearly summarized on the cover page of any notice to a party of any proposed or final settlement agreement.

(D) Identification of lawyers' representatives. The name, telephone number, and address of one or more representatives of counsel for the plaintiff class who will be reasonably available to answer questions from class members concerning any matter contained in any notice of settlement published or otherwise disseminated to the class.

(E) Reasons for settlement. A brief statement explaining the reasons why the parties are proposing the settlement.

(F) Other information. Such other information as may be required by the court.

(8) Security for payment of costs in class actions. In any private action arising under this title [*15 USCS §§ 78a* et seq.] that is certified as a class action pursuant to the Federal Rules of Civil Procedure, the court may require an undertaking from the attorneys for the plaintiff class, the plaintiff class, or both, or from the attorneys for the defendant, the defendant, or both, in such proportions and at such times as the court determines are just and equitable, for the payment of fees and expenses that may be awarded under this subsection.

(9) Attorney conflict of interest. If a plaintiff class is represented by an attorney who directly owns or otherwise has a beneficial interest in the securities that are the subject of the litigation, the court shall make a determination of whether such ownership or other interest constitutes a conflict of interest sufficient to disqualify the attorney from representing the plaintiff class.

(b) Requirements for securities fraud actions.

(1) Misleading statements and omissions. In any private action arising under this title [*15 USCS §§ 78a* et seq.] in which the plaintiff alleges that the defendant—

(A) made an untrue statement of a material fact; or

(B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;

the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

(2) Required state of mind. In any private action arising under this title [*15 USCS §§ 78a* et seq.] in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title [*15 USCS §§ 78a* et seq.], state

with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

(3) Motion to dismiss; stay of discovery.

(A) Dismissal for failure to meet pleading requirements. In any private action arising under this title [*15 USCS §§ 78a* et seq.], the court shall, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1) and (2) are not met.

(B) Stay of discovery. In any private action arising under this title [*15 USCS §§ 78a* et seq.], all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.

(C) Preservation of evidence.

(i) In general. During the pendency of any stay of discovery pursuant to this paragraph, unless otherwise ordered by the court, any party to the action with

actual notice of the allegations contained in the complaint shall treat all documents, data compilations (including electronically recorded or stored data), and tangible objects that are in the custody or control of such person and that are relevant to the allegations, as if they were the subject of a continuing request for production of documents from an opposing party under the Federal Rules of Civil Procedure.

(ii) Sanction for willful violation. A party aggrieved by the willful failure of an opposing party to comply with clause (i) may apply to the court for an order awarding appropriate sanctions.

(D) Circumvention of stay of discovery. Upon a proper showing, a court may stay discovery proceedings in any private action in a State court, as necessary in aid of its jurisdiction, or to protect or effectuate its judgments, in an action subject to a stay of discovery pursuant to this paragraph.

(4) Loss causation. In any private action arising under this title [*15 USCS §§ 78a* et seq.], the

plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this title [*15 USCS §§ 78a* et seq.] caused the loss for which the plaintiff seeks to recover damages.

(c) Sanctions for abusive litigation.

(1) Mandatory review by court. In any private action arising under this title [*15 USCS §§ 78a* et seq.], upon final adjudication of the action, the court shall include in the record specific findings regarding compliance by each party and each attorney representing any party with each requirement of Rule 11(b) of the Federal Rules of Civil Procedure as to any complaint, responsive pleading, or dispositive motion.

(2) Mandatory sanctions. If the court makes a finding under paragraph (1) that a party or attorney violated any requirement of Rule 11(b) of the Federal Rules of Civil Procedure as to any complaint, responsive pleading, or dispositive motion, the court shall impose sanctions on such party or attorney in accordance with Rule 11 of the Federal Rules of Civil Procedure. Prior to making a finding that any party or attorney has violated Rule 11 of the Federal Rules of Civil

Procedure, the court shall give such party or attorney notice and an opportunity to respond.

(3) Presumption in favor of attorneys' fees and costs.

(A) In general. Subject to subparagraphs (B)and (C), for purposes of paragraph (2), the court shall adopt a presumption that the appropriate sanction—

(i) for failure of any responsive pleading or dispositive motion to comply with any requirement of Rule 11(b) of the Federal Rules of Civil Procedure is an award to the opposing party of the reasonable attorneys' fees and other expenses incurred as a direct result of the violation; and

(ii) for substantial failure of any complaint to comply with any requirement of Rule 11(b) of the Federal Rules of Civil Procedure is an award to the opposing party of the reasonable attorneys' fees and other expenses incurred in the action.

(B) Rebuttal evidence. The presumption described in subparagraph (A) may be

rebutted only upon proof by the party or attorney against whom sanctions are to be imposed that–

(i) the award of attorneys' fees and other expenses will impose an unreasonable burden on that party or attorney and would be unjust, and the failure to make such an award would not impose a greater burden on the party in whose favor sanctions are to be imposed; or

(ii) the violation of Rule 11(b) of the Federal Rules of Civil Procedure was de minimis.

(C) Sanctions. If the party or attorney against whom sanctions are to be imposed meets its burden under subparagraph (B), the court shall award the sanctions that the court deems appropriate pursuant to Rule 11 of the Federal Rules of Civil Procedure.

(d) Defendant's right to written interrogatories. In any private action arising under this title [*15 USCS §§ 78a* et seq.] in which the plaintiff may recover money damages, the court shall, when requested by a defendant, submit to the jury a written interrogatory on the issue of each such defendant's

state of mind at the time the alleged violation occurred.

(e) Limitation on damages.

(1) In general. Except as provided in paragraph (2), in any private action arising under this title [*15 USCS §§ 78a* et seq.] in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

(2) Exception. In any private action arising under this title [*15 USCS §§ 78a* et seq.] in which the plaintiff seeks to establish damages by reference to the market price of a security, if the plaintiff sells or repurchases the subject security prior to the expiration of the 90-day period described in paragraph (1), the plaintiff's damages shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the

plaintiff for the security and the mean trading price of the security during the period beginning immediately after dissemination of information correcting the misstatement or omission and ending on the date on which the plaintiff sells or repurchases the security.

(3) Definition. For purposes of this subsection, the "mean trading price" of a security shall be an average of the daily trading price of that security, determined as of the close of the market each day during the 90-day period referred to in paragraph (1).

(f) Proportionate liability.

(1) Applicability. Nothing in this subsection shall be construed to create, affect, or in any manner modify, the standard for liability associated with any action arising under the securities laws.

(2) Liability for damages.

(A) Joint and several liability. Any covered person against whom a final judgment is entered in a private action shall be liable for damages jointly and severally only if the trier of fact specifically determines that such

covered person knowingly committed a violation of the securities laws.

(B) Proportionate liability.

(i) In general. Except as provided in subparagraph (A), a covered person against whom a final judgment is entered in a private action shall be liable solely for the portion of the judgment that corresponds to the percentage of responsibility of that covered person, as determined under paragraph (3).

(ii) Recovery by and costs of covered person. In any case in which a contractual relationship permits, a covered person that prevails in any private action may recover the attorney's fees and costs of that covered person in connection with the action.

(3) Determination of responsibility.

(A) In general. In any private action, the court shall instruct the jury to answer special interrogatories, or if there is no jury, shall make findings, with respect to each covered person and each of the other persons

claimed by any of the parties to have caused or contributed to the loss incurred by the plaintiff, including persons who have entered into settlements with the plaintiff or plaintiffs, concerning—

(i) whether such person violated the securities laws;

(ii) the percentage of responsibility of such person, measured as a percentage of the total fault of all persons who caused or contributed to the loss incurred by the plaintiff; and

(iii) whether such person knowingly committed a violation of the securities laws.

(B) Contents of special interrogatories or findings. The responses to interrogatories, or findings, as appropriate, under subparagraph (A) shall specify the total amount of damages that the plaintiff is entitled to recover and the percentage of responsibility of each covered person found to have caused or contributed to the loss incurred by the plaintiff or plaintiffs.

(C) Factors for consideration. In determining the percentage of responsibility under this paragraph, the trier of fact shall consider—

(i) the nature of the conduct of each covered person found to have caused or contributed to the loss incurred by the plaintiff or plaintiffs; and

(ii) the nature and extent of the causal relationship between the conduct of each such person and the damages incurred by the plaintiff or plaintiffs.

(4) Uncollectible share.

(A) In general. Notwithstanding paragraph (2)(B), [if,] upon motion made not later than 6 months after a final judgment is entered in any private action, the court determines that all or part of the share of the judgment of the covered person is not collectible against that covered person, and is also not collectible against a covered person described in paragraph (2)(A), each covered person described in paragraph (2)(B) shall be liable for the uncollectible share as follows:

(i) Percentage of net worth. Each covered person shall be jointly and severally liable for the uncollectible share if the plaintiff establishes that—

(I) the plaintiff is an individual whose recoverable damages under the final judgment are equal to more than 10 percent of the net worth of the plaintiff; and

(II) the net worth of the plaintiff is equal to less than $200,000.

(ii) Other plaintiffs. With respect to any plaintiff not described in subclauses (I) and (II) of clause (i), each covered person shall be liable for the uncollectible share in proportion to the percentage of responsibility of that covered person, except that the total liability of a covered person under this clause may not exceed 50 percent of the proportionate share of that covered person, as determined under paragraph (3)(B).

(iii) Net worth. For purposes of this subparagraph, net worth shall be

determined as of the date immediately preceding the date of the purchase or sale (as applicable) by the plaintiff of the security that is the subject of the action, and shall be equal to the fair market value of assets, minus liabilities, including the net value of the investments of the plaintiff in real and personal property (including personal residences).

(B) Overall limit. In no case shall the total payments required pursuant to subparagraph (A) exceed the amount of the uncollectible share.

(C) Covered persons subject to contribution. A covered person against whom judgment is not collectible shall be subject to contribution and to any continuing liability to the plaintiff on the judgment.

(5) Right of contribution. To the extent that a covered person is required to make an additional payment pursuant to paragraph (4), that covered person may recover contribution—

(A) from the covered person originally liable to make the payment;

(B) from any covered person liable jointly and severally pursuant to paragraph (2)(A);

(C) from any covered person held proportionately liable pursuant to this paragraph who is liable to make the same payment and has paid less than his or her proportionate share of that payment; or

(D) from any other person responsible for the conduct giving rise to the payment that would have been liable to make the same payment.

(6) Nondisclosure to jury. The standard for allocation of damages under paragraphs (2) and (3) and the procedure for reallocation of uncollectible shares under paragraph (4) shall not be disclosed to members of the jury.

(7) Settlement discharge.

(A) In general. A covered person who settles any private action at any time before final verdict or judgment shall be discharged from all claims for contribution brought by other persons. Upon entry of the settlement by the court, the court shall enter a bar order constituting the final discharge of all obligations to the plaintiff of the settling covered person arising out of the action.

The order shall bar all future claims for contribution arising out of the action—

(i) by any person against the settling covered person; and

(ii) by the settling covered person against any person, other than a person whose liability has been extinguished by the settlement of the settling covered person.

(B) Reduction. If a covered person enters into a settlement with the plaintiff prior to final verdict or judgment, the verdict or judgment shall be reduced by the greater of—

(i) an amount that corresponds to the percentage of responsibility of that covered person; or

(ii) the amount paid to the plaintiff by that covered person.

(8) Contribution. A covered person who becomes jointly and severally liable for damages in any private action may recover contribution from any other person who, if joined in the original action, would have been liable for the same damages. A claim for contribution shall be determined based on

the percentage of responsibility of the claimant and of each person against whom a claim for contribution is made.

(9) Statute of limitations for contribution. In any private action determining liability, an action for contribution shall be brought not later than 6 months after the entry of a final, nonappealable judgment in the action, except that an action for contribution brought by a covered person who was required to make an additional payment pursuant to paragraph (4) may be brought not later than 6 months after the date on which such payment was made.

(10) Definitions. For purposes of this subsection—

(A) a covered person "knowingly commits a violation of the securities laws"—

(i) with respect to an action that is based on an untrue statement of material fact or omission of a material fact necessary to make the statement not misleading, if—

(I) that covered person makes an untrue statement of a material fact, with actual knowledge that the representation is false, or omits to state a fact necessary in

order to make the statement made not misleading, with actual knowledge that, as a result of the omission, one of the material representations of the covered person is false; and

(II) persons are likely to reasonably rely on that misrepresentation or omission; and

(ii) with respect to an action that is based on any conduct that is not described in clause (i), if that covered person engages in that conduct with actual knowledge of the facts and circumstances that make the conduct of that covered person a violation of the securities laws;

(B) reckless conduct by a covered person shall not be construed to constitute a knowing commission of a violation of the securities laws by that covered person;

(C) the term "covered person" means—

(i) a defendant in any private action arising under this title; or

(ii) a defendant in any private action arising under section 11 of the Securities Act of 1933 [*15 USCS §§ 77j*], who is an outside director of the issuer of the securities that are the subject of the action; and

(D) the term "outside director" shall have the meaning given such term by rule or regulation of the Commission.

(g) [Redesignated]